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# BRITAIN
# THE STERLING AREA
# AND EUROPE

## ERRATUM

Page 25, line 15: *for* \$4,700 millions
*read* \$47,000 millions

Page 25, line 18: *for* one half
*read* one twentieth

# BRITAIN THE STERLING AREA AND EUROPE

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# TABLE OF CONTENTS

# *INTRODUCTORY NOTE*

THIS book is an attempt to elucidate the significance to Britain of actual and potential economic unions. The principal part of the book is in Chapters II and III. Chapter II deals with the sterling area, perhaps the most important economic union, of which the United Kingdom now is a member. It is an economic union of complementary economies. Chapter III deals with the economics of potential extension of Western European economic co-operation into the tariff sphere, and with the monetary union of this area of competitive economies. These two chapters attempt to bring out the salient points relating to economic unions in general, as well as in the particular cases dealt with, and are preceded by a short outline of Britain's present economic problem and general considerations of intensification and extension of the economy. It is against this setting that economic unions must be appraised. A theoretical statement on the all too frequently ignored external aspect of the customs union issue will be found in the appendix. No attempt is made to deal at any length with the political issues involved. This book is meant to be a study in applied economics, and not in politics, for it is important to separate as far as possible the analysis of economic issues and political issues. Then only is it possible to find out what political decisions imply in terms of economics.

Dr Vera Anstey very kindly spared the time to read the manuscript of this book, and made invaluable comments. Professor Joseph Sykes gave me encouragement and useful advice. Thanks to him, content and presentation of the book are much improved. I am obliged to Mr H. Burton, Mr A. R. Ilersic, Mr L. Little and Mr L. Pressnell for comments which they made. The University College, Exeter, gave a research grant which facilitated the preparation of the book. The

College also granted a loan which makes it possible to keep the published price of the book at a lower figure than otherwise would be possible with present-day production costs. I have received much courtesy and assistance from the library staffs of the Roborough Library, Exeter, and of the Royal Institute of International Affairs. The Financial Secretaries or Trade Commissioners of the High Commissions for the Dominions and the Commercial Counsellor of the Irish Embassy in London kindly supplied me with figures relating to the sterling balances of their countries. The Commercial Attachés' offices of the Belgian and French Embassies in London put some material at my disposal on Benelux and the proposed French-Italian economic union which otherwise would not have been easily available to me. To all these many thanks.

F. V. MEYER

Exeter
*April* 1952

CHAPTER I

# *THE INTENSIFICATION AND EXTENSION OF ECONOMIC ACTIVITY*

IF a farmer's plot of land does not yield the returns he considers necessary for his and his family's upkeep, he will think of ways of raising his productivity. He can raise his productivity by more intensive cultivation: by harder work on his own part, or — if he can afford it — by employing more labour or by applying more mechanized methods of production. The alternative to more intensive cultivation is more extensive cultivation — that is working over a larger area of land either by bringing under cultivation land he owns but had formerly neglected, or by acquisition of new land. Sometimes a combination of more intensive and more extensive cultivation will yield the highest returns. If neither more intensive nor more extensive cultivation is open to him, he is compelled to put up with his present standard of living, whether he grumbles or not.

Similarly, nations can be faced with the problem of more intensive or more extensive economic activity as alternative, or alternatives, to being content with the present standard of living. The intensification of economic activity may take the form of harder work. This need only be mentioned to show its limitations. In some countries people already work as hard as is humanly possible. In others longer hours are physically possible; but if carried too far, a lengthening of working hours can be self-defeating. The added fatigue may reduce the productivity per man-hour. To be overtired from yesterday's work decreases the efficiency of today's work. In Britain today, it would be physically possible to work longer hours. Yet the extra number of hours could not be expected to yield a proportionate return. Professor E. A. G. Robinson estimates that a return to the war-time numbers of hours worked in British industry might yield an extra output worth between

£300 and £400 millions a year.[1] On the basis of 1950 figures this would represent an addition of between 4½ and 6 per cent to the value of the gross output of industries covered by the index of production (manufacturing, mining, building and public utilities).[2] The increase in the average number of hours from the level of April 1950 to that of 1944 would represent an addition of 9 per cent to the hours worked by men and of 5 per cent to the hours worked by women. The general increase in the number of hours worked would be close on 8 per cent.[3] These estimates suggest that, even if a return to war-time working hours were possible, the physical output produced during the extra hours worked is likely to be less than proportionate to the extra labour involved. Moreover, the sacrifice in leisure involved would in any case be regarded as a lowering of the standard of living. This is no argument against longer hours should they be necessary for the defence effort. But the limit to any desirable extension of working hours in peacetime is decidedly below the 1944 level. The reason is that because of the probability of less efficient work during the additional hours, the additional work is likely to add to the inflationary pressure. It is impossible in present-day circumstances to remunerate the extra work at a lower wage rate per hour than the normal working hours. But if the average wage rate is paid for work of less than average value the effect is an increase in the ratio of money wages to the volume of goods. If other costs do not fall correspondingly, this is tantamount to an inflationary increase in wages. In fact most of the extra hours would have to be remunerated at overtime rates (i.e. more than average rates) which correspondingly increases the inflationary effect. The conclusion is that at present a substantial increase (possibly any increase) in working hours in Britain, while physically possible, is economically undesirable on the assumption that the increase in the volume of goods will be less than the increase in money wages. In other words the benefit of an increase in the volume of goods is likely to be more than offset by increased inflationary pressure. In view of this inflationary effect of longer hours in present-day conditions, longer hours of work cannot be advocated as a safe road towards a higher standard of living

[1] E. A. G. Robinson: 'The Economics of Rearmament', *Lloyds Bank Review*, January 1951, p. 21.

[2] As shown in *National Income and Expenditure of the United Kingdom, 1946 to 1950*, Cmd. 8203, Table 1, Items 2–6.

[3] Calculated from E. A. G. Robinson, op. cit., loc cit., and *Economic Survey for* 1951, Cmd. 8195, Table 2.

for the British people. One still can, and will, advocate longer hours for reasons of defence, but this is quite a different matter.

If longer hours are not a way of raising present living standards, what of more efficient utilization of the existing labour force? However, in so far as this can be done within the framework of existing laws and customs and with existing equipment, it is so manifestly in the interest of every single firm to do this, that any shortcomings in this sphere are bound to be remedied by individual firms at the earliest opportunity if it is in their power to do so. Therefore, it would be unrealistic to expect spectacular advances from redeployment of labour within the near future.[1]

One way of augmenting the labour force is immigration. This is the solution for the labour shortage in 'new' countries. It also was the solution adopted by France to cope with the labour shortage in her coal-mining areas in the inter-war years. However, it is very unlikely that there will be substantial net immigration into Britain for some time to come. The Royal Commission on Population found that any substantial number of immigrants could only come from Eire, Holland or Italy, and that 'it is very unlikely that it would be possible to obtain from these and other sources the numbers that would be needed to prevent the decline in the numbers of young adults during the next ten years'.[2] The correctness of this view was well illustrated by the experience of a recent British recruiting campaign for Italian mining labour. The number of potential immigrants available for this British 'undermanned' industry was found to be extremely limited and also competed for by other Western European countries, particularly Belgium.[3] On the whole, there is only a limited prospect of immigration of labour into any of the Western European countries that suffer from a labour shortage.

The third method of intensifying economic activity is by increased capitalization. This way out of current difficulties is the most hopeful of the 'intensive' solutions.

Whenever the economy does not produce an adequate supply of goods to satisfy effective demand at current prices, prices are bound to rise until production has caught up with effective demand or effective demand has been curtailed. Effective demand could be curtailed by a

[1] For a fuller discussion, cf. e.g., L. H. C. Tippett, 'The Essentials for Increased Productivity', *The Three Banks Review*, December 1950.

[2] cf. *Report of the Royal Commission on Population*, 1949, Cmd. 7695, para. 328.

[3] cf. *The Times*, January 1951.

general reduction in wages and other money incomes. If this is impracticable the inflationary situation will persist until the supply of goods has caught up with effective demand. True, the inflation can be 'suppressed' in the sense that the prices of some goods are not allowed to rise. However necessary and politically or socially desirable such control of inflation may be, controls cannot produce goods. A 'suppressed' inflation merely diverts purchasing power into non-controlled channels so that, irrespective of the political or social advantages of such diversion, the effects on the *general* level of prices is not so very different from the effects of a so-called 'open' inflation as is sometimes supposed. The inflation will continue until the supply of goods has caught up with money incomes. In the absence of foreign credits the supply of goods can only be increased either by increasing the efficiency of the economy through further capitalization, or by 'eating into capital'. Eating into capital can help the immediate problem, but only postpones the issue. Since the effect is less capital equipment in the long run, the issue is not only postponed, but also aggravated. Hence any deterioration of the capital stock at the disposal of the economy can only be advocated as a necessary evil of war economy. When national survival takes priority over everything else, including long-term living standards and long-term considerations of economic power, the running down of capital is often inevitable. In a peace economy the running down of capital equipment is no solution. The only sound policy is more capital formation.

If the economy has unemployed resources at its disposal, capital formation not only raises living standards in the long run, when its fruits will be reaped, it also helps the economy in the short run because it leads to a fuller employment of factors of production. Everybody who has read his Keynes knows that more investment is *the* solution for an under-employed economy. There is no conflict between what is desirable in the short run and in the long run.

The problem is more complex in a fully-employed economy. Capital formation diverts resources from production for current consumption. Those who are engaged on investment projects have to be remunerated before these projects mature. Money incomes are received before there is at least a counterbalancing increase in the volume of goods. Hence any increase in investment activity in a fully employed economy is inflationary in the short run.

If economic activity were determined solely or mainly by cyclical

fluctuations in trade, it would be justifiable to conclude that the present British investment programme is excessive. This can be illustrated by the position in 1949, the year with the least marked rise in prices since the war. In 1949 the general price level rose by 2 per cent. Gross capital formation absorbed approximately one-quarter of the national income. It follows that the reduction in gross capital formation that would have been required to offset the rise in prices would have been about 8 per cent of gross capital formation. Such a reduction of investment would have curtailed economic activity to a level at which investment could have been financed out of current savings. In that case the British economy would have worked at full employment without inflation. The 'excess' investment meant that resources had to be diverted to capital formation beyond the quantity of resources made available by genuine savings. The only way to secure these resources for investment activity was by forced savings, i.e. rising prices. In other words, 8 per cent of gross capital formation in 1949 was responsible for the 'over-full employment' of the British economy in that year. The cost of depreciation at replacement values absorbed at least half of gross capital formation in 1949. To make any cuts there would have meant eating into capital. The only cuts that could possibly have been made would have been cuts in net capital formation. Hence a cut of 8 per cent of gross capital formation would have prevented at least one-sixth of the total net capital formation in 1949.[1] In the other post-war years, to date, the appropriate cuts in net capital formation would have been larger.

One could advocate cuts in the investment programme of the magnitude indicated, if one expected a cyclical slump that would lead to an excess of savings over investment. If this were the expectation there would be an argument for postponing capital formation. However, 1949 was not a boom year. It was marked by a cyclical recession. Even so there were not enough savings to finance the capital programme without inflation. Nobody can say whether a text-book slump with savings exceeding investment will recur and when. But it would be highly dangerous to base policy on the assumption that the present inflation is a purely cyclical inflation. Just to decry the inflation and shout 'less investment' is not very helpful. For if there is a cyclical inflation going on at present, there also is another inflation operating

[1] Estimates based on figures in *National Income and Expenditure of the United Kingdom, 1946 to 1949*, Cmd. 7933, esp. Tables 1, 14 and 22.

side by side with it. To put it briefly, this second inflation is caused by a shortage of capital equipment caused by a relatively low rate of capital formation during the last generation, followed by the running down of capital equipment during the war. The result was that at the end of the war the economy could not produce as many goods as before the war. But money incomes had risen and could not be reduced proportionately. This problem has not yet been solved. Between 1946 and 1950 personal money incomes rose by 27 per cent, consumers' expenditure by 31 per cent, but the volume of goods bought by only 8 per cent.[1] If 1951 is included, with its special problems of rearmament, then the increase over 1946 of personal incomes was 37 per cent, of consumers' expenditure 41 per cent, and the volume of goods bought 8 per cent.[2] In 1945 the position was that money incomes exceeded the value of available goods at then current prices. Since money incomes were not reduced the inflationary pressure was fed every time that inflated money incomes were received, while the supply of goods had not caught up to meet all demands at current prices. This problem is cumulative and has not yet been overcome. But if the increase in the quantity of available goods is less than one-third of the increase in money incomes, as between 1946 and 1950, and if an appropriate reduction in money incomes is either impossible or undesirable, or both, the only way to overcome the inflationary pressure is by an increase in the supply of goods at more than three times the rate of increase that occurred between 1946 and 1950. If longer working hours and large-scale immigration of suitable workers are ruled out for the time being, then the only possible intensification of economic activity that can bring about the requisite increase in the quantity of goods is more capital formation. Until capital investment has led to the required increase in productive power, this second inflation will persist.

Thus, Britain's present day internal problem is one of two concurrent inflations. One is the cyclical inflation re-enforced by the rearmament boom. The cure for this inflation would be a cut in civilian investment. The other, perhaps more serious, inflation is one caused by under-capacity of existing equipment relatively to effective demand. This second inflation would be aggravated by any cut in investment.

[1] Calculated from *National Income and Expenditure of the United Kingdom*, 1946 *to* 1950, Cmd. 8203, Tables 11, 15 and 16.

[2] Calculated from op. cit., *Preliminary National Income and Expenditure Estimates*, 1948 *to* 1951, Cmd. 8485, Table 2; and *Economic Survey for* 1952, Cmd. 6509, Table 21.

If Britain were a closed economy, one might advocate a drastic slashing down of money incomes as the cure for the second inflation, so as to leave only the ordinary inflation to be dealt with in the ordinary text-book manner. But even if such a cure were politically feasible, it would not be a solution in the real world. For if we cut investment we impound future productive capacity for the sake of current consumption.

If we decided on this course, and other countries forged ahead, our exporting capacity would be reduced in volume and quality. Consequently the external value of the pound sterling would fall. The resultant deterioration in the terms of trade would bring in the inflation indirectly. For this problem the only solution is not to fall behind other countries, so that again the only possible way out of permanent inflation is capital formation now, even if it aggravates the temporary cyclical problem.

It remains as true today, as it always has been, that economic progress depends on savings devoted to capital formation. If the savings are available, economic progress is possible without inflation. This requires accumulated past savings that have not been spent on war. If these savings are not available in adequate quantity — as they hardly can be in a period following a total war — they must be forced on the economy through higher prices, i.e. forced savings (meaning forced non-consumption). The choice is between painful inflation now and protracted inflation at the expense of the future.

It is not intended to go into further detail of the inflationary problem in this book. The point has been dealt with at some length to indicate the difficulties of relying on intensification of economic activity alone to get out of our present difficulties. If we had to deal with a closed economy, problems of intensifying economic activity would be the only ones to be considered. In an economy that is closely interrelated with the outside world, other factors enter the picture and ease or complicate the problems

In the opening paragraphs of this chapter more extensive economic activity was mentioned as a possible alternative or supplement to more intensive economic activity. The most primitive form of extensive cultivation is the shifting cultivation which is still common in the forest area of Africa.[1] Extensified economic activity through settlement

[1] Hailey: *An African Survey*, Oxford University Press, 1938, pp. 1 and 879.

of new land on a large scale has not been possible in Western Europe for many centuries, but was open to Europeans in the settlement of the Americas and Australasia. In so far as there are possibilities of settling on new land in the Dominions and in Latin America this may be a solution for individuals. But in the countries of emigration, the labour shortage would be intensified. More extensive economic activity that is to help Britain and other Western European countries can only come about through expansion of international trade.

If we want an expansion of international trade it is essential to pursue the policy most likely to secure this end in present circumstances. We advocate as a means to this end the freeing of international trade from most controls, as it behoves moderate disciples of the classical economists. At the same time we aim to avoid a deficit and, if possible, to secure a surplus in our balance of payments, like more or less moderate mercantilists. Why this apparent illogicality in our thinking? It will be convenient to consider first some of the implications of favourable and unfavourable balances of payments to start with, on the assumptions that all lending is commercial lending, that rates of exchange are fixed and that the country under consideration is not encumbered with outstanding international debts.

An economy extends or narrows its sphere of operations according to whether it has a favourable or an unfavourable balance of payments with the outside world. A favourable balance of payments means an excess of the value of goods and services exported over the value of goods and services imported. In this case the residents of the country with the export surplus have supplied outsiders with more goods and services than are currently paid for by the outsiders. The 'surplus' goods and services supplied to outsiders will eventually have to be paid for. To that extent the export surplus country acquires a lien over production outside its frontiers. To put it differently: the export surplus is tantamount to an investment since both give command over future goods and services. It is therefore frequently called an 'export of capital'. This implies a corresponding import of securities. These securities are held in the surplus or lending country and give residents of such country a claim on outside resources. To that extent, production in the deficit or borrowing country is determined by criteria laid down in the lending country. These criteria are often purely economic ones without any political strings: the City of London was not often influenced by non-economic considerations in deciding on its

loans in the days of Britain's economic supremacy.[1] Nevertheless, irrespective of the principles of lending, a portion of the outside world's economy corresponding to the export surplus comes under the control or partial control of the lender. Lending takes place where the lender anticipates gain. True, borrowing is voluntary. Yet the lender decides where to put his money, having regard to the openings presented by potential borrowers. He ultimately decides whether to invest in, say, a railway line between *A* and *B* or between *C* and *D*, or whether to finance the expansion of crop *X* or crop *Y*. This decision depends on the lender's expectation of profits in the light of his interpretation of market forces as seen in his economic environment. The decision where the railway is to run or what crop is to be grown affects further decisions about economic activity in the borrowing country through the usual multiplier effects. Lending does not only enable the original project to materialize, but also can be the cause of a variety of further activities resulting from the original project. None of this contradicts the fact that a loan is normally at least as important to the borrower as to the lender and is normally expected to alleviate the borrower's poverty by as much as, or more than, it increases the lender's wealth — at any rate proportionately, if not also absolutely. However, the lender acquires some control over the borrower's activities, in addition to the claim for repayment with interest. In international lending, the lending country not only acquires the right to future goods and services to the extent of the export surplus plus interest. It also acquires some control over outside economic activity. The extent of this latter control is not necessarily directly proportionate to the size of the export surplus. It depends on the proportion of the finance for a project provided by the lending country and on the multiplier effects of the project. The higher the proportion of finance for a project supplied by a single country, and the greater the multiplier effects of that project, the more dependent is the borrowing country on the lending country. Thus, the export surplus leads to a measurable extension of the surplus country's economic activity (capital plus interest), and may also lead to a degree of control over the borrower's economic activities that cannot be easily calculated.

If the export surplus country has to repay past debts, the extension

[1] cf. e.g. United Nations: *International Capital Movements in the Inter-War Period*, Lake Success, 1949; and H. Feis: *Europe, the World's Banker, 1870 to 1914*, Yale University Press, 1930.

of its economic sphere of operations into the outside world is correspondingly less. Since, however, outsiders' claims on the domestic economy are reduced, the domestic economy still expands, although in this case it cannot exert any influence over outside economic activity. A complication arises when a country is a debtor *vis-à-vis* one part of the world, but a creditor of the rest of the world. If, for example, the United Kingdom has a balance of payments deficit with the dollar area and a surplus with the rest of the world, the American economy extends into the British, and the British economy extends into the rest of the world. Whether the British economy as a whole extends or contracts still depends on the total balance — whether the surplus with the rest of the world exceeds or falls short of the dollar deficit. It must be borne in mind, however, that this extension or contraction of the economy will hardly ever be uniform in all directions; and that only the acquisition of claims for repayment is directly proportionate to the export surplus, but not the acquisition of control over the borrowing economy. To the extent to which the post-war deficit of the United Kingdom with the dollar area was covered by Marshall Aid grants, Britain did not become liable to repayments on a commercial basis and did not lose control over any of her resources.

It should be stressed in this connection that American generosity in granting Marshall Aid was not confined to giving goods and services that could not be paid for out of current earnings. Had the United States offered loans on a commercial basis there could have been no complaints. She has, however, chosen to give this aid largely in the form of non-recoverable grants and left the distribution of available funds largely in the hands of the Office of European Economic Co-operation. Had the United States chosen to give aid in the form of direct loans she would have acquired claims for repayment and could have investigated each individual project before putting her money on it. The fact that in such case Western Europe would probably have borrowed on a substantially smaller scale enhances the value of Marshall Aid to Europe. The United States did not exploit Europe's post-war weakness, as she could have done simply by insisting on the highest possible interest rates. The United States also decided to forego any

Marshall Aid has not united Western Europe it has at any rate 'un-divided' it. By not using every advantage she would have been entitled to under the generally accepted rules of commercial lending, the United States did not exploit the weakness of others who had suffered more from the war.

This does not mean to say that government lending must always be more welcome to borrowers than private lending. Government lending on commercial terms without due regard to commercial principles of profitability might lead to over-lending and over-borrowing — as sometimes happened during the inter-war years. If, as a result of an economically unjustified loan, the borrowing country cannot repay and has to submit to the appointment of a receiver, the political sovereignty of the borrowing government is impaired in favour of the lending government.

We must now abandon the assumption of fixed rates of exchange. Could not the whole balance of payments problem be avoided by means of flexible exchange rates? Would not then the surplus country's currency appreciate and the deficit country's currency depreciate, so that a balance between imports and exports could be obtained by this means? The surplus country would import more and the deficit country import less and the accounts would become even. This argument confines itself to the balance of payments as it appears on paper and ignores that a surplus in the balance of payments implies an economy that extends its sphere of operations as a result of more rapid expansion than takes place elsewhere, while the deficit implies contraction. If we resorted to flexible exchanges this process of expansion and contraction would not show up in the paper accounts, but would proceed all the same. The surplus economy would not necessarily have a surplus in the accounts, but would be able to buy from the rest of the world on increasingly favourable terms. The deficit economy would lose more and more of the fruits of its own labour in buying whatever it needs from the 'surplus' country on increasingly unfavourable terms. In short, fixed rates of exchange are a form of protection for the weaker economies. For them it means that the deficit does not immediately lead to such deterioration in the terms of trade. If loans are available, the deficit countries have a chance to increase their productivity and thus ultimately right the balance without this heavy cost. If no loans are available — or only in insufficient quantity — then the weaker economy's currency cannot remain over-valued and

equilibrium will be forced on it the hard way. But as long as loans are available, a fixed rate of exchange is a cushion for the weaker economy against 'selling out', even if the accounts do not look so neat.

As long as the economies of the various countries of the world progress at unequal rates, there will be this over-spill of the stronger ones into the weaker ones. The effect is cushioned by loans which give the weaker economies a chance to advance faster than they could had they to rely on their own resources. If the loans are well spent then the borrowing economy can expand despite the lender's lien over a portion of its output, i.e. production can increase by more than the annual debt repayments. This requires commercial sagacity on the part of borrower and lender. The clever commercial lending of the City of London before 1914 led to an extension of the British economy into the outside world, and helped to accelerate the growth of other economies. The world economy as a whole expanded because of this extension of British economic activity. On the whole British overseas lending was a source of international goodwill. In contrast to this stands the inter-war period, when much international lending was on a non-commercial basis. Political loans cannot be expected to lead to the commercial expansion in the debtor economy that would be required to make repayment easy. The result is ungrateful and defaulting borrowers and exasperated lenders. Political loans for non-commercial projects, coupled with commercial conditions of repayment, may well lead to more international ill-will than no loans at all. The borrower whose economy does not expand sufficiently resents the lender's hold over his economic activities and will try to repudiate his debts in order to protect his economic sovereignty.

The unequal rate of growth of the economies of the countries of this world is often considered as one of the causes of international economic rivalries. But it also intertwines these economies in a way that otherwise would not be possible. It makes it possible for the more rapidly advancing economies to lend some of their savings to others. At the time the loan is made this gives the borrower a right over some of the lender's resources and, if the loan is wisely invested, accelerates the borrower's economic progress. When repayments fall due, the lender has a right to some of the borrower's products. In either case one economy obtains goods not currently earned. It extends its activities beyond its borders. This is in effect one form of economic union.

It might be contended that this exposition unduly stresses the lender,

rather than the borrower. This gives the argument a certain unbalance. To stress the lender's part in capital transactions stresses the aspect of the problem that relates to relative economic power and power politics. The argument appears more or less mercantilistic. If the borrower's part had been stressed the argument would have been much more in terms of economic welfare.

In times when capital is relatively plentiful the stress should be on the borrower's part. When capital is so plentiful that potential lenders' desire to obtain an outlet for their funds exceeds potential borrowers' desire to become borrowers, the borrowers can fairly freely decide on the purposes for which they will want to take up loans. The borrower then decides whether and for what purposes he will be prepared to assume the obligations he has to incur in return for a loan. While the lender can refuse to lend at all times, the borrower has the whip hand in times of capital abundance. Considerations of borrower's welfare predominate.

At present, capital is scarce. There is more demand for loans than there are resources to lend. The lender clearly has the whip hand. His relative strength is due to the shortage of capital. Moreover, at all times the potential lender is wealthier than the potential borrower, hence economically stronger. It follows that the lender is stronger in times of capital scarcity than the borrower can ever be in times of capital abundance. At the time of writing the emphasis in the argument must be on lending.

It may however be argued that none of this contradicts the fact that if there is an export surplus, home-produced goods are taken away from current domestic consumption, and to this extent the export surplus is inflationary. An import surplus increases the amount of goods available in the country without extra current effort and without any current payment. The argument is the same as in the case of current investment *versus* current consumption. An import surplus (unless covered by gifts from abroad) is equivalent to a running down of our capital resources. It narrows the economic potential of the future, since a portion of future production will be earmarked for the consequent repayments. Future welfare is sacrificed for current welfare, or to put it differently, future inflation is substituted for current inflation. The export surplus does the opposite. It aggravates any current inflationary problems for the sake of anti-inflationary effects in the future.

An export surplus can be used or misused as an instrument of economic power. It can be employed for the development of overseas resources that are needed by the lending economy, but cannot be produced by it, or not in sufficient quantities. This was the aim of the old colonial system, of imperialism, and also of the Overseas Food Corporation. In each of these cases a union with a complementary economy was sought for the benefit of the lending country. Where such activity was successful in the past, it often led to production in excess of the lender's requirements. In such case the lender could reap the fruits of his investment only if some of the output were sold to other countries, even if in return goods had to be accepted that competed with domestic production. According to a United Nations study of capital movements, this made Free Trade profitable to nineteenth-century Britain.[1] Once the lender believes in Free Trade, or at any rate in multilateral trade, lending will be undertaken, not only if the project is complementary to activity in the lending country, but simply where it is most profitable. The most profitable investment yields the highest returns and where currencies are freely inter-convertible this benefits the lending country most, irrespective of whether the investment is in goods directly needed by the lending country or not.

At present we are a long way from Free Trade and even multilateral trade is not yet in sight. Despite her favourable current balances of payments in 1949 and 1950 Britain still could not afford non-discriminatory multilateral trade even in 1950. The reason is the so-called dollar shortage. This is somewhat of a misnomer. For it suggests as cause the United Kingdom balance of payments deficit with the dollar area. But this deficit was larger before the war than it is now. Multilateral trade was possible then. Britain could afford the deficit with the dollar area because she could sell on demand manufactured goods to primary producing countries which, in turn, had a surplus with the dollar area. Britain could buy dollar goods freely, not only by direct trade, but also by selling her exports to countries that sold some of their products to the dollar area and spent some of their earnings on buying British goods. There was no special difficulty in obtaining the required amount of dollars *via* this multilateral trade, so that sterling and dollar were freely interchangeable without undue stress on either currency. Such free convertibility of one currency into another in its turn is the basic pre-condition for non-discriminatory

[1] United Nations: *International Capital Movements in the Inter-War Period*, p. 47.

multilateral trade. It is impossible now because sterling could not yet stand the strain.

Even now Britain's dollar imports are to a large extent financed out of British sales to third countries. The weak link in the chain is Britain's inability to supply an adequate quantity of goods on demand to such third countries, particularly since this demand is swollen by sterling debts Britain had incurred during and since the war. Hence some of Britain's exports are unrequited, and the volume of unrequited exports would increase if the holders of the sterling debts were allowed to convert these balances into dollars. The value of these sterling balances is equivalent to approximately one-third of the annual national income of the United Kingdom. A considerable portion of these balances is required by some of the creditor countries as a monetary reserve, so that the potential claims on British resources are less. But freedom to convert even, say, one-third of these balances into dollars at one stroke would put an intolerable burden on the British economy. If sterling were made freely convertible substantial conversions would take place for the simple reason that the British economy could not supply an equivalent quantity of goods without complete breakdown. As long as some sterling balances cannot be freely converted into other currencies, exchange control must continue and there can be no unrestricted multilateral trade between the sterling area and the outside world.

If the holders of the sterling balances were allowed to draw on their accounts without limit, the United Kingdom might be called upon to transfer to her creditors anything up to one-third of the current national income. The United Kingdom clearly could not surrender such a large slice of her current output in total, let alone in the form of such goods as the creditors most urgently require (largely capital goods). Hence the alternatives are default *via* inflation (rising prices deprive these balances of their real value), or investment of such funds in the United Kingdom (in the form of blocked accounts, as is the case with about one-third of these balances at present, or in the form of purchase of United Kingdom securities), or, if immediate realization were desired beyond the United Kingdom's capacity to pay, by conversion of these sterling balances into dollars. In the latter case the creditors would buy American goods which their debtor (the United Kingdom) would have to pay for. Thus, either the sterling creditors or the United States, as ultimate supplier of the goods, would be entitled

to about one pound in three that are earned in the United Kingdom in the current year, or the capitalized value of this debt. Thus, if the creditors were to realize their loans all at once, the effect might well be a substantial conversion of United Kingdom debt to the present holders into United Kingdom debt to the United States. A foretaste of this was experienced during the short period of sterling convertibility in 1947. True, in 1947 only currently earned sterling became legally convertible into dollars. However, there was a considerable leakage from 'old' to 'new' sterling. Control does not seem possible without control of all kinds of sterling conversions.

The mere transfer of indebtedness from one creditor to another would not hurt the United Kingdom were it not for the fact that the present holders have to a large extent currencies tied to sterling. A conversion of a sterling debt into a dollar debt means a conversion of a debt that can be repaid out of national production in general into a debt that can be repaid only out of that portion of national production that is dollar earning. To ease the burden of repayment of a sterling debt we require an increase in the national income. To ease the burden of repayment of a dollar debt we may also require a shift in our economic structure so as to produce the goods that are most wanted in the dollar area or other overseas economies that are prepared to pay in dollars. Such a shift is not necessarily in the direction of most rapid increase in the national income. There is something of a vicious circle in this position. There would be no such difference between a sterling debt and a dollar debt if sterling and dollar were freely interchangeable. But because our indebtedness is so huge we cannot afford free convertibility of sterling into dollars, since it would lead to a plethora of sterling relatively to the dollar and a further fall in the value of the pound.

Thus, multilateralism must wait from the United Kingdom's point of view, not only because of the quantitative burden of her indebtedness, but also because it implies at least some convertibility of sterling debts into dollar debts. In any case, unduly rapid debt redemption enhances the inflationary pressure and thus endangers the value of the pound. The United Kingdom's sterling creditors too have, on the whole, preferred patience to unduly rapid realization of the debts. Even if they could realize part of their balances more quickly, if the result were a loss in value of any remainder (through a fall in the value of sterling) they might lose as much as, or more than, they would gain. Also if

their currencies are tied to sterling their own currencies would lose value to the same extent, so that they certainly would lose. Even the United States might not be too pleased with the results. However rich the United States is, there is a limit to what she can do. For example, on 31st December 1950, the sterling balances amounted to £3,757 millions,[1] which at the rate of exchange of £1=$2.80 is approximately $10,520 millions. Compare this with the value of United States exports of goods and services in 1950 of $14,351 millions and the United States national income in 1950 of $244,000 millions.[2] If only, say, £1,000 millions ($2,800 millions) of the sterling balances could have been used for immediate purchases in the United States, the pressure on United States resources would have been equivalent to about one-fifth of her 1950 exports, though only between 1 and 1½ per cent of her 1950 national income. Most of this demand would have been for capital goods. Since gross domestic investment accounted for $4,700 millions or 19 per cent of the gross national product of the United States in 1950,[3] this assumed additional demand for £1,000 millions worth of capital goods would have competed with over one-half of United States gross capital formation. This example indicates how such additional pressure on United States resources would either intensify the inflation in the United States or would lead to a substantial rise in the external value of the dollar. In either case the creditors would lose some of the real value of their balances and this cost to them must be added to the cost they would have to bear through the effects of unduly speedy action on the value of sterling. (Of course, if sterling falls in value, the dollar becomes more valuable in terms of sterling, and if the dollar appreciates sterling loses relative value. In this case, however, we are concerned with two independent movements of the relative value of the two currencies, each of which would raise the dollar in value relatively to sterling, and both acting simultaneously would aggravate the position.) Whatever the effects on the United Kingdom and the sterling creditors, the United States herself could not view such a situation with equanimity. The effects of aggravated inflation would be undesirable for domestic reasons. The effects of an appreciation of the dollar might lead to substantial losses of export markets for the United States. Moreover the acquisition of further claims on the United

[1] Source: Cmd. 8201, Table 16.
[2] Source: *Survey of Current Business*, April 1951.
[3] op. cit.

Kingdom would not be an unmixed blessing to the United States. If she insisted on immediate payment she would produce a collapse in the United Kingdom and thus waste all her Marshall Aid to the United Kingdom and more. Gradual repayment would be more within the realm of the possible, but considering the uncertainty of the United Kingdom balance of payments position it is doubtful if the United States would ever be able to insist on repayment without producing heavy strains on the British economy and the pound sterling. Since the giver of Marshall Aid cannot be suspected of such intentions, a freeing of the sterling balances might well mean that the United States would pay most of the debt. Thus, neither the United Kingdom, nor the sterling creditors, nor the United States could be certain of anything but loss, if there were a sudden removal of control over the sterling balances. Since the rest of the world could not fail to be injured by a further weakening of sterling and by dollar inflation or dollar appreciation, it is difficult to see who would benefit from free convertibility of sterling in present circumstances. Thus, non-discriminatory multilateral trade must wait until the United Kingdom's sterling debts to overseas countries are largely paid off or sterling is otherwise strengthened.

The best way of strengthening sterling is through an expansion of the United Kingdom economy, be it through intensification or extension of this economy's sphere of operations. Which of the various possible policies would be the one that reaches our goal most quickly depends on economic circumstances and the political repercussions of each method. In each case the economic criterion is whether costs are reduced in relation to anticipated profits. In a stable economy, where market opportunities are neither widening nor contracting, this implies actual cost reductions. In a declining economy, where markets are shrinking, these cost reductions must more than outweigh the expected loss of markets. In an expanding economy, where the general expectation is one of constantly widening sales opportunities, there need be no actual cost reductions to lower the ratio of costs to anticipated profits. Moreover, cost reduction depends largely on investment. The burden of the overhead and other fixed costs that will have to be borne in consequence of such investment takes up a larger share of the total anticipated receipts in a declining market than in an expanding one. The best stimulus for industrial expansion is the prospect of a widening market.

Sometimes it is suggested that the comparatively large size of the United States home market explains why the United States is more prosperous than any European country. However, size of market is a relative concept, and there appears to be no logical reason for restricting it to the home market. If the argument in the preceding paragraph is true, then it is growing size of markets that matters rather than the absolute size at any one point of time.

From the point of view of size of markets, relatively to the burden of inescapable production costs, the British economy has fared rather badly during the last generation, if not longer. Population is not expanding at a rapid rate, so that the vista of an automatically expanding home market no longer provides the spur to industrial expansion as it did from the 1780's to the 1870's. That was a period of exceptional population growth (about 1½ per cent per annum) and exceptional growth of manufacturing output (between 2 and 4 per cent per annum).[1] Overseas demand for British merchandise exports expanded rapidly during the first two-thirds of the nineteenth century. Thereafter growth was less rapid, and in the inter-war years there was an actual decline. The balance of payments continued to be favourable until the 1930's (except 1876-8), thanks to the growth of service trades and the export of capital.[2] None of these stimuli to the British economy are likely to operate in the near future. Population increases only slightly. Though so far all fears of an absolute decline in population have been belied by events, at present the prospect seems to be a stable, perhaps slightly rising, population. An increase in manufacturing exports has been achieved in the post-war years. However, the share of exports in national production was about the same in 1948 (15 per cent) as it was before the war (14 per cent in 1938.) In 1950 and 1951, after devaluation, it was about 20 per cent in money terms.[3] The increase in manufacturing exports does not yet ensure a favourable balance of payments. Moreover, any export drive that attemps to push more and more of our goods on to world markets is costly. We can sell more abroad without cost if world income and world trade increase correspondingly. But an 'export drive' implies that we aim at a bigger share of world trade than before. This means we must sell more and more

[1] cf. W. Hoffman: *Wachstum und Wachstumsformen der englischen Industriewirtschaft von 1700 bis zur Geganwart*, Gustav Fischer, Jena, 1938.

[2] cf. C. K. Hobson: *The Export of Capital*, Geo. Allen and Unwin, London, 1913, and official figures.

[3] cf. National Income White Papers.

goods that become more and more difficult to sell, i.e. the terms of trade will deteriorate. This cost would be reduced if there were a shift in world demand towards the goods we can sell without readjustment of our economic structure. There is no evidence for this. The cost can also be reduced to the extent to which we can readjust our economic structure to enable us to sell abroad goods in expansible demand. To some extent this has happened: engineering goods have become more important relatively to textile in our exports. The shift has not been big enough, however, to counteract the other forces that have caused the deterioration of Britain's terms of trade after the war. Yet it was important. Not the least cost of the defence programme is that fewer engineering goods will be available for export, so that we shall have to rely on the export of other goods that are more difficult to sell, i.e. the terms of trade will deteriorate. This will make it more difficult than ever to spare the resources required for a balance of payments surplus.

A balance of payments surplus depends on domestic savings, just as much as any other investment activity. If these savings are not voluntarily forthcoming the surplus may yet be attained if the requisite amount of savings (non-consumption) is forced on the economy by inflation. At present, the supply of voluntary savings is inadequate for current investment needs of all kinds. The supply of such savings depends on industrial profits and the size of private incomes. Profits and incomes rise when the economy expands. When the economy is expected to expand, saving for investment purposes becomes more attractive. Yet the prospects for rapid expansion of the British economy through population growth or extension into overseas economies though by no means hopeless, are far from certain.

Moreover, the sphere of operations of the civilian economy is narrowed by every increase in the defence programme. Unless international relations suddenly improve there is no hope of any cut in defence expenditure. Defence requirements fall heavily on the capital goods producing industries. If defence should cost 10 per cent of the national income, the proportion of this cost cannot be evenly spread, but will absorb a much larger percentage share of the output of the engineering industries.

While defence narrows the sphere of operation of the civilian economy in general, the Welfare State narrows the sphere of operations of the industrial economy. The Welfare State is highly desirable,

but it has to be financed out of taxation and local rates. Our tax and local rates bill reduces our consumption, but reduces our actual or potential savings even more. As taxes and rates increase, the potential supply of private and corporate savings is reduced. Simultaneously our progressive system of taxation redistributes incomes and favours those with a relatively high propensity to consume as against those with a relatively high propensity to save. It is not intended to argue the case for or against the Welfare State here. It is only desired to point out that where a country has great economic power (in the sense of an adequate, or more than adequate, supply of capital goods) such power should certainly be used for the furtherance of human welfare; but the requirements of the Welfare State compete with capitalization, i.e. creation of economic power.

The situation described above is by no means hopeless. Internally we shall have to invest as much as we can. The defence programme might even help here in the long run. It will require further investment in engineering and, to the extent to which the new plant and equipment can be used for civilian purposes, this will strengthen the civilian economy if and when defence preparations can be scaled down. The speed of the post-war conversion of the engineering industry suggests that the prospect is encouraging. Perhaps the future historian will be able to say that the defence programme brought us investment where we needed it most (i.e. in capital-creating industry) of a scale we otherwise would have thought we could not afford.

Externally, Britain does not stand alone. The British economy is strengthened by the existence of the sterling area, and in a different way by European economic co-operation. It is the purpose of this study to show in what ways these economic unions strengthen the British economy, and to try to answer the question whether further steps in the direction of union with the sterling area and Europe could give the British economy a stimulus to expansion which otherwise would be unattainable. It is against the setting sketched in this introductory chapter that economic unions must be appraised in present circumstances.

CHAPTER II

# THE STERLING AREA

## 1. AREA AND DEFINITION

The sterling area can be described as a monetary union between the United Kingdom and the overseas Commonwealth, with the important exception of Canada. The overseas sterling area is officially known as 'the scheduled territories' or as 'Rest of Sterling Area' (R.S.A.). Membership has not always been confined to the Commonwealth. Before the war it included several foreign countries. There is some prospect of its extension into parts of Continental Europe.[1] However, at the time of writing, the sterling area is a Commonwealth monetary union, including a few countries that used to be connected with the Commonwealth, i.e. the Irish Republic, Burma, Iraq, and Jordan. The only present member of the sterling area that always has been a foreign country is Iceland.

The R.S.A. consists of predominantly primary producing economies. In some of these countries, manufacturing is becoming increasingly important. For example, in Australia 25 per cent of the working population is now employed in manufacturing industries.[2] Yet the predominant feature of all the R.S.A. economies in world trade still is primary production. On the whole the R.S.A. is complementary to the manufacturing economy of the United Kingdom.

## 2. ORIGIN AND RULES

In its origins the sterling area can be described as a legacy of the gold standard. When the international gold standard collapsed during the

[1] See Chapter 3B.

[2] cf. United Nations: *Statistical Yearbook*, 1949 *to* 1950, New York, 1950, Table 8; note: Australian figures relate to 1947.

depression of the 1930's and Great Britain went off gold, most Empire countries (the exceptions being Canada, Newfoundland and British Honduras) and several foreign countries preferred to have their currencies linked to sterling rather than to stay on gold or to establish independent paper currencies. This gave the R.S.A. countries the advantage of continued stable exchange rates with the United Kingdom, their principal trading partner. It gave the United Kingdom the advantage that the prices of a substantial proportion of her food and raw material supplies were not subject to ups and downs caused by fluctuations in rates of exchange.

The United Kingdom has never imposed any restrictions on the inward or outward flow of private sterling funds from and to the R.S.A., but the Government-held war debts to the R.S.A. had to be partly blocked.[1] In the R.S.A. the exchange controls established in New Zealand in 1938 and in Australia in 1939 did not allow for freedom of transactions even with the sterling area. While the two dominions controlled sterling transactions less strongly than other transactions, under their controls free inter-convertibility of sterling currencies became a one-way traffic. Nevertheless Australia and New Zealand remained members of the sterling area.[2] Again, in 1952, severe restrictions were imposed on imports from all sources into Australia, New Zealand and the Union of South Africa. These restrictions in no way prejudice the continued adherence of these dominions to the sterling area.

The rules of the sterling area, as evolved to date, do not seem to require more from R.S.A. countries than to fix the value of their currencies in terms of the United Kingdom pound sterling at whatever parity they choose, and to impose as few restrictions on current sterling transactions as circumstances permit. The United Kingdom's role in the sterling area is in the first place to have a sound currency herself, and secondly through the Bank of England to administer the sterling reserves of the member countries. This requires that the United Kingdom must not restrict the in- and out-flow of current sterling between herself and the R.S.A. Any such restrictions would make it impossible for the Bank of England to act as banker for R.S.A.

[1] See Section 5.

[2] cf. J. F. Nimmo: *Australia and New Zealand: Developments in Trade and Finance,* University of London and Institute of Bankers, Lectures on the Sterling Area No. 3, 8th December 1948, pp. 6-8.

countries. To these tasks has been added the administration of the Sterling Area Gold and Dollar Pool. Sterling is not now freely convertible into gold or dollars, so that a reserve of gold or dollars is necessary for the transactions of the sterling area with outside countries. The joint dollar pool means that the sterling area acts jointly as far as its dollar problems are concerned. This is necessary for the continuance of the sterling area. The dollar is now the world's chief currency. Every central bank accepts dollars without limit. The value of all other currencies is quoted as so and so many dollars. If each member of the sterling area administered its own dollars, the value of each of the member currencies would fluctuate independently in terms of dollars. There would then be no fixed rate of exchange between sterling area currencies. There would be no sterling area. Before the war, when sterling was freely convertible into all other currencies and generally accepted as a means of international payments, the sterling area was held together by the United Kingdom administration of the R.S.A.'s sterling reserves. Now that the pound sterling has to be subject to exchange control, the sterling area's reserves of means of international payments consist for some purposes of the jointly administered sterling reserves, and for all purposes of the gold and dollar reserves. In short, the function of the United Kingdom in the sterling area is to act as administrator of the area's generally acceptable means of international payment.

### 3. STABLE EXCHANGES

One of the chief advantages generally attributed to the sterling area is that it gives its members the benefits of stable exchange rates in their mutual trade. In this way it does in a more limited area what the gold standard used to do the world over. In the gold standard days of the later nineteenth century it was advantageous for most countries to have their currencies linked to gold, because sterling was linked to gold. Britain then was the world's foremost trading power. It was considered advantageous for countries to have their currencies linked to gold or sterling if Britain was their principal trading partner or if their principal trading partners had linked their currencies to gold or sterling. Stability of the exchanges removes some risks from international trade. It is provided by a common monetary standard.

The experience of India before 1893 is a good example of the disadvantages of having one's currency on a different standard from the standard of the chief trading partner. In those days the Indian

rupee was based on silver, while sterling was on gold. The price of silver kept falling in terms of gold. Hence the rupee continuously depreciated in terms of sterling. After the stabilization of the Indian rupee in terms of sterling in 1893, Indian exports increased.[1] Undervaluation of the currency stimulates exports only if it is 'stable undervaluation' in the sense that the currency is kept at a permanent and unchangeable artificial discount below its proper value in terms of gold or another principal currency. If it is intended to encourage exports and to discourage imports a stable undervaluation can secure the desired result. But if the currency constantly depreciates so that the degree of undervaluation continuously increases, then the present value is higher than what it is expected to be in the near future even if its present value is too low. Orders for exports from a country with such a currency will be delayed as long as possible. The currency will be treated as if it were overvalued. In fact it is 'overvalued' compared with its own anticipated value, although it may be undervalued in terms of other currencies. If the depreciation of the currency, say, the rupee in terms of sterling is not continuous, but there are frequent fluctuations in its value, British buyers will tend to buy spasmodically, that is whenever they think the rupee is at its lowest value for some time. This concentration of purchases occurring in a short time causes a sudden short-lived appreciation of the rupee. When these purchases slacken off, the rupee depreciates again, and this depreciation is accentuated by anticipations of a further fall. India did not solve all her currency problems in 1893. But once the principle of stable exchange rates between the rupee and sterling was established, at any rate the difficulties of continuous depreciation were overcome.[2]

Persistent overvaluation will always discourage exports and encourage imports, unless it is expected that the overvaluation will be regularly intensified. The latter can happen only if there is a persistent demand for a country's currency. This will be the case only if that country is an important creditor, or if its currency is in general demand for the purpose of accumulating monetary reserves in that currency. In such case, orders for exports from the country with the appreciating currency will be speeded up. Unlike the case of persistent

[1] cf. J. M. Keynes: *Indian Currency and Finance*, Macmillan, London, 1913, p. 3.

[2] For details on Indian currency experience, cf. Keynes, op. cit., and Vera Anstey: *The Economic Development of India*, 3rd Edition, Longmans, Greene, London, 1936, Chapter XV and op. cit. there.

depreciation this process cannot go on indefinitely without harming the appreciating country's exports because of their rising cost to the buyers. Excessive overvaluation may even lead to difficulties in obtaining imports, since overvalued currencies may be accepted in payment only at a discount. The danger of overvaluation was shown by the experience of India immediately after the first world war. India had emerged from the first world war as a (temporary) creditor. It was wrongly expected that this state of affairs would continue. Therefore the post-war parity of the rupee was fixed at an unduly high level. The result was that the export trade was hard hit, imports rose to unprecedented heights and the sterling reserves dwindled.[1]

Thus, in the sterling area system, as in any other currency system it is necessary not only to have stable exchanges, but also stable exchanges that at least roughly represent the true relative values of member currencies. Day-to-day fluctuations are avoided by stable exchanges, but when the exchanges no longer reflect true longer period parities, the appropriate adjustments have to be made. It is quite compatible with the sterling area system to vary the sterling parity of member currencies. Thus, between 1920 and 1925 the rupee was allowed to find its own level before a new parity was fixed. The Australian pound was taken off gold in 1929 and the new sterling exchange rate was not fixed until 1931; and the New Zealand pound similarly was allowed to fluctuate between 1931 and 1933.[2] Pakistan in 1949 raised the value of her rupee relatively to other sterling area currencies simply by her refusal to follow the British devaluation of that year; New Zealand up-valued her pound in 1950. Thus changes in parities are not incompatible with membership of the sterling area — they may indeed be essential for its continued functioning. Such changes can be made at one stroke (cf. the recent examples of Pakistan and New Zealand). They may be made also with an interval of fluctuating exchange rates, as long as it is generally expected that the fixing of a new long-term parity with the United Kingdom pound sterling is the ultimate aim of the monetary authorities of the country concerned, and its international means of payment continue to be administered by the Bank of England (cf. the examples of India in the 'twenties and of Australia and New Zealand in the 1930's).

[1] cf. Vera Anstey: op. cit., loc. cit., especially pp. 421-424.

[2] For full details of changes in sterling area currency parities see *League of Nations International Currency Experience*, Geneva, 1944, pp. 50-54.

In any consideration of the advantages of stable exchange rates it is necessary to distinguish between stable exchange rates secured, because the currencies concerned are pegged to a common neutral denominator and stable exchanges that result from currencies being pegged to each other. For instance, both the Australian pound and the New Zealand pound are pegged to the United Kingdom pound sterling at fixed parities. This gives Australia and New Zealand stable exchange rates with the United Kingdom. Since the United Kingdom pound sterling is the common neutral denominator in terms of which the values of the Australian and New Zealand currencies are fixed, there are stable exchange rates between the Australian and New Zealand pounds. If £NZ.100=£st.100, and £A.125=£st.100, £NZ.100=£A.125. The use of the common neutral denominator as the basis of their currencies removes the risks of fluctuating exchange rates from the trade relations between Australia and New Zealand.

It is still necessary that the rate of exchange between the £A and the £NZ should as nearly as possible represent the relative values of the Australian and New Zealand currencies. Failing that, faulty currency valuations will result in strains and stresses on the two dominions' trade with each other and on their trade with third countries where they compete for supplies or markets. Given correct exchange rates, however, the two dominions enjoy without qualification the full advantages of stable exchange rates between their currencies.

More important than stable exchanges in intra-R.S.A. trade is the stability of the exchange rates between the United Kingdom and the R.S.A. It is of special importance to the R.S.A. countries to have monetary stability with the United Kingdom, one of the principal trading partners in all cases and the principal trading partner in most cases, particularly since the United Kingdom is one of the world's greatest commercial powers. It is equally important for the United Kingdom to have this monetary stability in her trade relations with the R.S.A. countries which in 1950 took 45 per cent of her exports and supplied 40 per cent of her imports.[1] The advantage of monetary stability in such a large proportion of overseas trade probably outweighs any of the qualifications that have to be made. It is important, however, to distinguish between the effects of exchange stability

[1] cf. *Economic Survey for* 1951. Cmd. 8195, Table 17.

between the United Kingdom pound sterling and the R.S.A. currencies, and the effects of exchange stability between any two of the R.S.A. currencies.

Within the sterling area, the United Kingdom pound sterling is the basic currency. It is necessary for the R.S.A. countries to have an adequate supply of sterling securities if their currencies are to be sterling currencies and they wish to avoid internal and external monetary stringency. Hence there is a demand for sterling in excess of the demand for current commercial purposes. While R.S.A. countries are building up their monetary sterling reserves, there is a premium on sterling, so that its value is higher than it otherwise would be. In the absence of counterbalancing factors, the result is an overvaluation of sterling. This affects current commercial transactions: the terms of trade move in favour of the United Kingdom and against the R.S.A., so that imports from the R.S.A. into the United Kingdom are encouraged and exports from the United Kingdom to the R.S.A. are discouraged. This is advantageous to the United Kingdom in that it yields the United Kingdom economy more R.S.A. goods than she would otherwise be currently able to buy. In return for her services as administrator of the R.S.A.'s international means of payment, the United Kingdom economy is able to extend into the R.S.A. economies to a greater extent[1] than she otherwise could. Once the R.S.A. countries have adequate monetary sterling reserves this premium on sterling disappears. If the R.S.A. has more than adequate monetary sterling reserves the process is reversed. Sterling can be disposed of by countries other than the United Kingdom. The supply of sterling is greater than the supply needed for current commercial needs. In the absence of counterbalancing factors, sterling stands at a discount. Sterling becomes undervalued for the purpose of current commercial transactions. Imports into the R.S.A. from the United Kingdom are encouraged and exports from the R.S.A. to the United Kingdom are discouraged. The terms of trade move against the United Kingdom and in favour of the R.S.A. The United Kingdom economy contracts.[2]

## 4. THE NINETEEN-THIRTIES

In the 1930's the R.S.A. countries had to build up their sterling reserves. The sterling area had come into being in 1931, when most

[1] In the sense defined in Chapter I, p. 16.
[2] In the sense defined in Chapter I.

countries' gold and foreign exchange reserves were at a minimum. An adequate supply of sterling was essential for the R.S.A. countries as backing for their currencies.

Details for the whole sterling area do not appear to be available, but for fifteen major sterling area countries[1] there was an increase in sterling reserves from £151 millions in 1929 (boom) and £82 millions in 1931 (depression) to £254 millions in 1937 (boom) and £216 millions in 1938 (depression).[2] These figures are too low for the R.S.A. as a whole, since only fifteen countries are included. However, the trend is correctly shown. This can be seen also from figures showing the United Kingdom's total external liabilities. In those days practically all the external liabilities of the United Kingdom were sterling liabilities. They rose from £411 millions in December 1931, to £808 millions in December 1937, and then fell to £598 millions in December 1938, and £542 millions in June 1939.[3] These figures include liabilities to non-sterling area countries. But they show the same trend as the previous ones and equally support the following statements.

In 1931 the R.S.A.'s sterling reserves were inadequate as monetary reserves. By 1937 and 1938 they were still insufficient for some R.S.A. countries, but adequate and more than adequate for others. In those years sterling was, on the whole, undervalued as a result of the activities of the Exchange Equalization Account. This does not exclude the possibility of overvaluation in relation to R.S.A. countries. These countries were free to fix their exchange parities at whatever rate they chose. They chose rates that were satisfactory to themselves[4] — if by 'satisfactory' is understood a rate that encourages exports. None of the R.S.A. countries fixed their sterling rate of exchange at a higher level than it was before Britain's departure from the gold standard in 1931 and some went substantially below the old parities. For example, Australia and New Zealand fixed their new sterling exchange parities 20 per cent below the old.[5] Therefore, such overvaluation of the United Kingdom pound sterling in terms of R.S.A. currencies as there was in the 1930's was not the result of deliberate policy on the part of the United Kingdom, but the result of the choice of sterling parities

[1] Australia, Denmark, Egypt, Eire, Estonia, Finland, India, Latvia, New Zealand, Norway, Palestine, Portugal, Sweden, Thailand, Union of South Africa.

[2] cf. League of Nations, op. cit., Appendix III, p. 236.

[3] *Reserves and Liabilities*, 1931 *to* 1945, Cmd. 8354, Table III.

[4] League of Nations, op. cit., p. 54.

[5] ibid., p. 51.

by the R.S.A. countries themselves. Even when sterling funds became adequate for monetary purposes for some R.S.A. countries, the undervaluation of their currencies was preferred to a departure from stable exchange rates; e.g. in Australia 'in 1933-4, when funds were piling up in London and there was some fear that the exchange rate might be lowered, the trading banks sold London funds to the Commonwealth Bank'.[1] Sweden and Finland, in those days members of the sterling area, preferred to avoid the inflationary effect of balance of payments surpluses in 1936 and 1937 by a reduction in public investment and a rise in their budget surpluses, rather than to allow their currencies to appreciate in terms of sterling.[2] It is doubtful whether such policies would have been continued if there had been a continuous further increase in sterling balances. However, it is idle to speculate on what would have happened had there been no war. In those days it seemed reasonable not to up-value an R.S.A. currency in response to an accumulation of sterling balances in relatively prosperous years. Prices of primary products fluctuated more heavily than prices of manufactures, so that a fall in sterling balances had to be expected in a depression. This actually happened in 1938. Nevertheless, in retrospect it appears that the undervaluation of some R.S.A. currencies in terms of sterling had served its purpose by the end of the 1930's and would not have been continued indefinitely.

What of the United Kingdom? Any improvement in her terms of trade was welcome since it raised the standard of living. In so far as the undervaluation of R.S.A. currencies contributed to this improvement in the terms of trade, it benefited the United Kingdom. In times of full employment it would not be necessary to enter a *caveat*. The 1930's, however, were a period of widespread unemployment in Britain.

The favourable movement in the terms of trade made British goods relatively expensive and any undervaluation of currencies abroad accentuated this tendency. Primary producers were already impoverished by the movement in the terms of trade against primary products, and this was one (though not the only) cause of the difficulties of the British export trade. The undervaluation of R.S.A. currencies was bound to add to these difficulties.

[1] ibid., p. 53, quotation from D. B. Copland: 'Some Problems of Australian Banking', *Economic Journal*, 1937, p. 694.

[2] ibid., pp. 52-3.

It is necessary to attempt a quantitative assessment of this pressure on sterling in the 1930's. It must be borne in mind, however, that detailed figures are not available for the sterling reserves of all the R.S.A. countries, nor are figures available for the sterling reserves administered for the R.S.A. by the Bank of England. Moreover, numerous other factors influenced the trade and currencies of the countries concerned. It is always a hazardous task to attempt to isolate one factor in a complex situation. Nevertheless, if these limitations are realized, and if the following estimates are taken as no more than rough indications of the pressure put on the pound sterling by the building up of R.S.A. sterling reserves in the 1930's, some interesting results can be obtained.

The following compares changes in sterling balances with United Kingdom exports. One comparison is between the annual increase or decrease of total central foreign exchange reserves of fifteen R.S.A. countries with the corresponding changes in the British export trade to these countries. In the case of R.S.A. countries it is legitimate to presume that these central foreign exchange holdings were held largely in sterling.[1] The countries included are Australia, Denmark, Egypt, Eire, Estonia, Finland, India, Latvia, New Zealand, Norway, Palestine, Portugal, Sweden, Thailand, and the Union of South Africa. The most important omission is the British colonial empire.

Another comparison is between the annual change in the total external liabilities of the United Kingdom and her total export trade — bearing in mind that not all of these liabilities were due to the R.S.A.

Let $A$ be the rate of increase (+) or decrease (−) over the preceding year of the central foreign exchange holdings of the fifteen named R.S.A. countries[2];

let $B$ be the value of United Kingdom exports to the same fifteen countries[3];

let $C$ be the rate in increase (+) or decrease (−) over the preceding year of the total external liabilities of the United Kingdom[4];

let $D$ be the value of United Kingdom exports to all destinations.[3]

[1] ibid, p. 54.
[2] Based on figures, ibid., p. 236.
[3] Source: *Statistical Abstract for the United Kingdom.*
[4] Based on figures in Cmd. 8354, loc. cit.

| | | 1932 | 1933 | 1934 | 1935 | 1936 | 1937 | 1938 | TOTAL 1932–8 |
|---|---|---|---|---|---|---|---|---|---|
| *A* | £ millions .. | + 26 | + 59 | + 41 | + 2 | + 11 | + 33 | − 38 | +134 |
| *B* | £ millions .. | 147 | 148 | 173 | 186 | 195 | 225 | 214 | 1,288 |
| *C* | £ millions .. | + 57 | + 70 | + 42 | + 20 | +121 | + 87 | −210 | +187 |
| *D* | £ millions .. | 365 | 368 | 396 | 426 | 441 | 521 | 471 | 2,988 |

The accumulation of sterling reserves meant that currently earned sterling was withdrawn from commercial use. These funds were used for the accumulation of monetary balances instead of being spent on United Kingdom exports. True, not all these funds would have been spent in the United Kingdom in any case. However, had they been spent on commercial transactions elsewhere, third countries could have bought more from the United Kingdom. The ratio of *A* to *B* indicates by how much United Kingdom exports to the fifteen countries could have been higher if these countries had spent all their exchange earnings on United Kingdom goods rather than United Kingdom money. The ratio of *C* to *D* indicates the maximum amount by which total United Kingdom exports could have been higher had no country accumulated sterling funds. The negative figures for 1938 indicate the reduction of exports that would have followed on these assumptions had there been no withdrawal of sterling reserves:

| Ratio | 1932 | 1933 | 1934 | 1935 | 1936 | 1937 | 1938 | TOTAL 1932–8 |
|---|---|---|---|---|---|---|---|---|
| *A* to *B* .. % | 18 | 39 | 24 | ·1 | 5 | 14 | −18 | 10 |
| *C* to *D* .. % | 16 | 19 | 11 | 5 | 27 | 17 | −45 | 6 |

The exact mechanism by which the pressure on sterling was exercised depended on whether the sterling balances were acquired through direct transaction with the United Kingdom or in transactions with other countries. In the former case there was an increase in competition for Treasury bills, in which form these balances were kept. This

reduced the amount of Treasury bills available for commercial bank assets and led to a shortage of bills. Since Treasury bills formed an important part of the commercial banks' liquid assets, this, 'if not actually deflationary acted at any rate as a check on the expansion of credit'.[1] If the R.S.A. exchange reserves were acquired in transactions with non-sterling countries such foreign exchange or gold was sold to the Exchange Equalization Account for Treasury bills. In this case the new R.S.A. demand for Treasury bills was matched by releases of such bills by the Exchange Equalization Account.[2]

Hence there was no direct deflationary effect on bank credit. However, since the R.S.A. monetary authorities acquired these Treasury bills for the purpose of building up monetary reserves, these bills were withdrawn from the market. Normally, the effect of a release of Treasury bills by the Exchange Equalization Account in return for gold or foreign currency acquired was to increase the supply of sterling securities and to decrease the supply of gold or foreign currency on the market, i.e. the value of sterling was reduced by increasing its supply and reducing the potential demand for it. If these Treasury bills were withdrawn from the market into the R.S.A. monetary reserves, the supply of sterling securities was reduced again. The value of sterling was still kept down since the R.S.A. got the bills only by surrendering gold or foreign exchange, but not by as much as if the bills had remained in the market. The net result was not an actual raising of the value of sterling, but to keep it at a higher level than otherwise might have been the case. In other words, the effect was not actual overvaluation of sterling *vis-à-vis* non-sterling currencies, but less undervaluation than might otherwise have resulted from the activities of the Exchange Equalization Account.

None of this is an argument against the sterling area system. In the circumstances of the 1930's it was the best monetary system that was available to the United Kingdom and the R.S.A. countries. The trade of the sterling area recovered from the depression more rapidly than world trade. Between 1932 and 1938 the annual change in the United Kingdom export trade to the fifteen named R.S.A. countries was on the average +7 per cent; to the rest of the world +2 per cent. Although there were other factors at work that tended to bring about this result, to say the least it is very doubtful whether this would have been so

[1] League of Nations, op. cit., p. 61.
[2] ibid., loc. cit.

marked in the absence of the stability of exchange rates within the sterling area. Nevertheless, it is important to realize the difference between the effects of stable exchanges in terms of a neutral denominator and stable exchanges between the monetary centre and other member countries. Where the exchanges are stabilized in terms of a neutral denominator, the benefits of stable exchanges are enjoyed without cost, as in the case of exchange stability amongst the R.S.A. currencies.

In the case of stable exchanges between the monetary centre and other member currencies, the position is complicated, at any rate in the early years of such a monetary union, by the effects of the monetary stock-piling of the member countries. To repeat, in the circumstances of the 1930's this monetary stock-piling of R.S.A. countries cost the United Kingdom perhaps between 6 per cent and 10 per cent of her export trade. Against this must be set the benefits of exchange stability within the area. These appear to have counter-balanced much of this cost. Secondly, the expansion of bank credit in the United Kingdom was checked somewhat. Thirdly, the under-valuation of sterling caused by the activities of the Exchange Equalization Account was in minor degree counteracted.

These cost factors are important during the period when monetary reserves are inadequate, that is particularly during the first few years of the working of such a monetary union. The figures showing the annual change in the exchange reserves of the fifteen R.S.A. countries on p. 40 suggest that monetary stock-piling was at its heaviest in 1933 and 1934. The increases in 1936 and 1937 were due largely to the relatively favourable raw material prices that prevailed during those years; this raised the earnings of most R.S.A. countries and their reserves beyond what was absolutely necessary for monetary purposes. The withdrawal of sterling balances in 1938 suggests that the sterling balances of those fifteen countries were by then in excess of minimum monetary needs and were used to maintain these countries' imports during a bad year for primary producers. The same applies to total overseas sterling holdings. Hence, against the cost of the increase in sterling reserves in 1936 and 1937 must be set the advantage of reduced fluctuations in trade. While not too much should be deduced from the experience of only one cyclical turning point, the figures suggest that once the reserves had been built up to a size adequate for minimum monetary requirements (by about 1935) it was possible to use additional

reserves (earned in 1936 and 1937) as a kind of monetary buffer stock against the next depression (1938).

To return to the cost factor: Not all of the cost was borne by the United Kingdom. The accumulation of monetary sterling reserves meant that R.S.A. imports were reduced below current exchange earnings, so that real incomes were reduced in the countries concerned. This was accentuated where R.S.A. currencies were undervalued to facilitate such monetary stock-piling, though in these cases there may have been some compensating benefits for the level of employment. To illustrate how far the accumulation (+) of sterling balances appears to have reduced imports, and how far the withdrawal (−) of sterling balances appears to have enabled R.S.A. countries to buy additional imports, the following figures for the two largest Empire holders of sterling reserves in the 1930's are given.[1]

| | | INDIA | | | AUSTRALIA | | |
|---|---|---|---|---|---|---|---|
| | | 1932–4 | 1935–8 | 1932–8 | 1932–4 | 1935–8 | 1932–8 |
| i | Net Change in Central Foreign Exchange Reserves .. £ million | +36·5 | −9·4 | +27·1 | +25·9 | −7 | +18·9 |
| ii | (i) as Percentage of Balance of Trade Surplus % | 108 | 8 | 18 | 32 | 16 | 15 |
| iii | (i) as Percentage of Imports of Merchandise % | 13 | 2 | 3 | 16 | 2 | 3 |

Had there been no sterling area, the R.S.A. countries would not have been better off. After the financial crisis of the early 1930's it would, in any case, have been necessary to accumulate new foreign exchange reserves. Had it not been sterling it would have had to be gold or dollars or any other third currency. They chose sterling because the United Kingdom was their principal trading partner and it was easier

[1] Calculated from League of Nations, op. cit., p. 236 and Statistical Abstract for the British Empire. Indian trade figures relate to the 12 months commencing 1st April of the year shown, Australian trade figures relate to the 12 months ending 30th June of the year shown. Hence the figures for the two countries are not strictly comparable. If there is a time-lag between earning and spending the Australian figures illustrate our point more accurately in (ii) and the Indian ones in (iii).

for them to earn sterling than other currencies. The adoption of different currency basis would have been more costly and would have taken longer. It is remarkable how quickly some R.S.A. countries built up their monetary reserves. If a reduction in a country's sterling reserves before the cyclical turning point of 1937-8 can be regarded as a sign that sterling reserves had become adequate, or even more than adequate, for current monetary requirements, then Australia had reached the goal by 1934, Egypt, New Zealand and Palestine by 1935, and India by 1936.[1]

The United Kingdom bore most of the cost of the sterling area in the 1930's since it somewhat added to the deflationary tendencies in the British economy. But, if the United Kingdom had remained on gold, or had she adopted a dollar or franc or any other exchange standard, some United Kingdom funds would have been tied up in a monetary stock-pile that were instead available for the purchase of imports. Real incomes in the United Kingdom would have been lower, though there might have been some stimulus to employment, especially in the export trades. However this may be, in building up a currency system upon a national currency, the supplier of this currency cannot escape some deflationary pressures that result from the monetary stock-piling of the other members of the currency bloc.

These costs had to be borne only during the initial stages. They were counterbalanced by the beneficial effects in real incomes in the United Kingdom. Which of the two forces was strongest can be indicated by a comparison of the changes in the balance of payments on current account and the size of the sterling reserves of R.S.A. countries. An unfavourable balance of payments means that the current real income is kept above current earnings, but a persistently unfavourable balance of payments will ultimately lead to a lowering of the value of the deficit country's currency and thus tend to restore the balance. In other words, in so far as the country's real income depends on its international transactions, a persistently unfavourable balance of payments will ultimately lower the country's real income compared with the present real income. In the 1930's the United Kingdom's balance of payments showed an increasing tendency towards deficit. If we add up the United Kingdom's balance of payments deficits between 1932 and 1938[2] the total comes to £180 millions.

[1] cf. League of Nations, op. cit., loc. cit.
[2] Sources: Board of Trade Journal and Cmd. 7324.

That is, £180 millions of United Kingdom money were supplied to the world in excess of world demand for United Kingdom goods and services. Nevertheless, there was no corresponding fall in the value of the pound sterling. This was due to a variety of factors, but an important one was the monetary stock-piling of the R.S.A. The fifteen R.S.A. countries mentioned previously[1] accumulated approximately £134 millions during the same period, which reduces the figure for the 'excess supply' of sterling in the 'thirties to £46 millions. Accumulations of sterling by all countries amounted to £187 millions. It does not seem rash to conclude that the effect of the United Kingdom's balance of payments deficits on the value of the pound sterling was offset by the R.S.A.'s monetary stock-piling, or at any rate reduced to insignificant proportions. Details are as follows:

| | 1932 | 1933 | 1934 | 1935 | 1936 | 1937 | 1938 |
|---|---|---|---|---|---|---|---|
| *a* United Kingdom Balance of Payments Surplus (+) or Deficit (−) £ millions | − 51 | 0 | − 7 | + 32 | − 18 | − 56 | − 70 |
| *b* (*a*) PLUS Net Increase or Decrease of Central Foreign Exchange Holdings of 15 R.S.A. countries[2] £ millions | − 25 | + 59 | + 34 | + 34 | − 7 | − 23 | −108 |
| *c* (*a*) PLUS Net Increase or Decrease of Total External Liabilities of the United Kingdom[3] £ millions | + 6 | + 70 | + 35 | + 52 | +103 | + 31 | −280 |

The tentative conclusion is that the sterling area system kept the value of sterling at a somewhat higher level that would appear justified from the balance of payments position between 1932 and 1937. The reason is that the 'excess supply' of sterling caused by the unfavourable balance of payments in most of those years was absorbed in monetary stock-piles. The withdrawal of sterling balances in 1938, however, led to an increase in the quantity of current sterling in overseas hands

[1] p. 39.
[2] See (*A*) on p. 39.
[3] See (*C*) on p. 39.

beyond the quantity that had to be paid out to finance the balance of payments deficit.

It is possible that the position in 1938 was exceptional; that the withdrawal of sterling balances was due to cyclical causes or due to the political uncertainties during that year. If so, then towards the end of the 'thirties the prospect was the enjoyment of the benefits of stable exchanges in the sterling area without further deflationary effects in the United Kingdom, without the reduction of real income in the R.S.A. because of the self-denial of imports of goods and services for the sake of monetary stock-piling and without the initial effects of these monetary stock-piles on the value of sterling.

## 5. THE STERLING BALANCES 1945–51

Whatever the prospects may have been in 1938, by 1945 the position was quite different. The United Kingdom emerged from the war as a substantial debtor. In 1945 it was estimated that the United Kingdom had increased her external liabilities by at least £2,879 millions between September 1939 and June 1945.[1] Practically all of these war-time liabilities were sterling debts. The total sterling liabilities of the United Kingdom at the end of June 1945, amounted to slightly above £3,500 millions.[2] Hence at least four-fifths of the United Kingdom's sterling liabilities at 30th June 1945 were in excess of sterling balances that had been built up in the past for monetary and current trade purposes. Between 1945 and 1951 the total of these sterling balances fluctuated somewhat from year to year. By 31st December 1951 it was £3,807 millions.[3,4] If allowances are made for changes in the value of the pound and any possible increased demand for sterling for monetary purposes, it still appears that the post-war increase in the United Kingdom's external sterling liabilities was due rather to further debts incurred by the United Kingdom for military expenditure and to tide over current difficulties, than to other countries' desire to hold more sterling.

Not all of these debts are due to R.S.A. countries. Some of the creditors have left the sterling area, others never were members. In so far as they were not incurred in the United States and Canada, practically all the debts the United Kingdom has contracted since 1939 are sterling debts.

[1] cf. *Statistical Material Presented during the Washington Negotiations*, Cmd. 6707, Table 9.
[2] cf. 416 H.C. DEBs., 5s., Col. 728.
[3] Excluding £566 millions to non-territorial organizations.
[4] cf. *United Kingdom Balance of Payments*, 1948 *to* 1951, *No.* 2. Cmd. 8505, Table 15.

This is as much a sign of the strength of sterling as of the sterling area itself. Normally, debts are contracted in the creditor's currency. Debts in the debtor's currency can be incurred only if the creditor regards the debtor's currency as safer than his own. The existence of the United Kingdom's sterling debts are proof of the creditor's confidence in sterling at the time the debts were incurred. This is quite natural in the case of the R S.A. countries whose currencies are tied to sterling, but quite a compliment from the others. Even in the case of the R.S.A. countries it should be remembered that, with the possible exception of the colonies, they are free to leave the sterling area whenever they want to do so.

To say that it is a sign of strength that a country can borrow in its own currency does not imply that the country can go on borrowing without limit if its currency is not to be weakened. This is particularly so in the case of borrowing from countries in other currency areas. Hence priority must be given to reduction of debts to countries outside the sterling area. Were this not done, sterling would be weakened at the expense of all sterling area countries. It is therefore satisfactory that the proportion of that debt to non-sterling countries has been reduced.[1]

| Proportion of United Kingdom Sterling Liabilities due | | *at 31st December* | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | 1945 | 1946 | 1947 | 1948 | 1949 | 1950 | 1951 |
| To Colonies .. .. | % | 12 | 13 | 14 | 16 | 17 | 20 | 25 |
| To other R.S.A. .. | % | 54 | 52 | 50 | 53 | 52 | 53 | 48 |
| To Non-Sterling Countries | % | 34 | 35 | 36 | 31 | 31 | 27 | 27 |

Nonetheless, the problem of the United Kingdom's total sterling indebtedness is not yet anywhere near solution. Reference has been made in Chapter I to the way in which this heavy (to a large extent, non-economic) indebtedness of the United Kingdom weakens the United Kingdom in world trade and how it impedes a return to a non-discriminatory system of multilateral trade. In this chapter we are restricting our attention to the effects of the United Kingdom sterling debts on the sterling area.

[1] Calculated from figures in op. cit., loc. cit., and Cmd. 8201, Table 16.

The present plethora of sterling tends to undermine the value of sterling, to encourage exports from the United Kingdom and to discourage imports into the United Kingdom and to accentuate the movement of the terms of trade against the United Kingdom.

To assess the importance of these tendencies it is necessary to attempt an estimate of how far the United Kingdom's external sterling liabilities exceed any possible monetary demand for sterling. In order to arrive at a fairly exact estimate it would be necessary to have detailed figures of the sterling holdings of each country. Such figures are not available. The United Kingdom authorities publish figures for total sterling holdings of groups of countries (colonies, other R.S.A. and non-sterling countries), but preserve banker's secrecy regarding individual countries' holdings in their charge. Sometimes the position regarding individual holdings is made known by the financial authorities of the creditor countries or in specific agreements between individual creditor countries and the United Kingdom. Such knowledge assists our estimates, but it must be borne in mind that what happens to the sterling balances of, say, India, is not necessarily relevant to the future of the sterling balances of, say, Australia. In any case, even if detailed figures were available for each holder of sterling balances, the future monetary sterling requirements could not easily be calculated on the basis of such figures, since this depends on the future of world trade and the commercial and currency policies of the countries concerned. The necessity to work with aggregate figures deprives our calculation of some statistical neatness, but has the advantage that it avoids a misleading appearance of minute accuracy. All we can attempt to do is to show a fairly wide range within which we expect the 'excess supply' of sterling to lie. This shows that the situation is not as alarming as suggested by a crude comparison of the total United Kingdom sterling debts with the United Kingdom national income, nor as comforting as the widely held belief that the monetary demand for sterling is nearly as great as these sterling liabilities.

The first approach is to compare the total war-time increase in sterling liabilities of £3,149 millions[1] with the total United Kingdom sterling liabilities to all countries at the end of 1951 of £3,807 millions.

[1] £2,879 millions to June 1945 (Cmd. 6707), plus £270 millions during the second half of 1945 most of which was for military expenditure (419 H.C. DEBs., 5s., Col. 405 and 416 H.C. DEBS., 5s., Col. 228).

This crude comparison suggests that 83 per cent of the sterling balances are in excess of monetary requirements.[1] This is an over-estimate. Some of the war-time debts have been repaid, though new ones have been contracted. The value of money has fallen and deprived these debts of perhaps one-third of their real value. If it is legitimate to assume that this leads to a corresponding increase in the monetary sterling requirements of the creditors, then the excess of our total sterling liabilities is below three-quarters of the total. The alternative approach which follows suggests that three-quarters of the total is an over-estimate.

The other approach is to compare the sterling balances held on restricted (or blocked or funded or No. 2) account with sterling balances held on unrestricted (or free or current or No. 1) account. Sums held on unrestricted account can be used freely, subject only to the exchange control regulations of the sterling area. With some countries the United Kingdom has concluded agreements by which the creditors agreed to keep part of their balances in restricted accounts. Funds in restricted accounts cannot be drawn upon except by agreement between the creditor country and the United Kingdom to transfer specified amounts from restricted account to unrestricted account. Such funding agreements have been concluded with Argentina, Brazil, Burma, Ceylon, Egypt, India, Iraq, Israel, Italy, Jordan, Norway, Pakistan, Portugal, Sweden, Switzerland and Uruguay.[2] In June 1950, approximately £1,300 millions were held on restricted account and approximately £2,200 millions on unrestricted account.[3] If it is legitimate to assume that the sterling balances on restricted account represent the sterling balances that are in excess of monetary and commercial requirements, then 37 per cent of the United Kingdom's external sterling liabilities to all countries on 30th June 1950 were 'excess balances'. This certainly is an under-estimate. There are sterling balances in excess of monetary requirements owned by countries with whom no funding agreements have been concluded. In several instances this is so because the monetary authorities of the countries concerned work in such close co-operation with the United Kingdom monetary authorities that no formal treaties are necessary

[1] If the figure for 31st December 1950 (£3,743 millions) is chosen, the percentage is practically the same (84 per cent).
[2] cf. 444 H.C. DEBs., col. *157*. 448 H.C. DEBs., Col. 207. 460 H.C DEBs., col. *53*.
[3] cf. 478 H.C. DEBs., col. *325*.

to enforce restraint. This is the case with the colonies. The United Kingdom's sterling liabilities to the colonies have steadily increased from £447 millions at the end of 1945 to £964 millions at the end of 1951.[1] It is likely that a substantial proportion of these balances is in excess of the colonies' monetary requirements. The same applies to other R.S.A. countries, e.g. Australia and New Zealand. It would not appear rash to conclude that the excess balances in 1950 and 1951 are not likely to have been less than about half of the total

These estimates are only very rough. But they enable us to say that the volume of United Kingdom external sterling liabilities to all countries is substantially swollen by United Kingdom debts beyond the level of sterling funds required by R.S.A. and other countries for monetary and ordinary commercial purposes. In 1950 and 1951 these excess balances appear to have been somewhere between one-half and three-quarters of the total.

Any sterling balances that have been accumulated in excess of the holder's monetary and commercial requirements have to be repaid. This gives rise to the problem of unrequited exports. Goods have to be exported without current or future return; our exports are increased relatively to our imports so that the import-buying power per unit of our exports is reduced, i.e. the terms of trade are moved against us. In 1947 and 1948 the total of the sterling balances was reduced by £124 millions and £183 millions respectively. These sums are equivalent to 11 per cent of the exports of merchandise from the United Kingdom in either year; if invisible exports are included, 8 per cent in either year. Given the actual exports in 1947, the balance of payments deficit of the United Kingdom in the absence of these repayments, would have been £421 millions instead of £545 millions; in 1948 there would have been a surplus of £157 millions instead of a deficit of £26 millions. Given the actual balance of payments deficits in these two years, then in the absence of these repayments, exports could have been less by the amounts shown, or alternatively imports of merchandise could have been 8 per cent higher than they actually were in 1947, and 10 per cent in 1948. If invisible imports are included the percentages are 6 and 8 respectively. The actual deterioration of the United Kingdom's terms of trade was 10 per cent in 1947[2], and 5 per

[1] cf. Cmd. 8201 and Cmd. 8505. Subsequent figures in this section taken, or calculated, from same sources unless source stated.
[2] cf. *Monthly Digest of Statistics.*

cent in 1948.[1] On the assumption that a five per cent movement in the terms of trade on the basis of 1948 figures changes the United Kingdom balance of payments account by £100 millions,[2] the actual deterioration of the terms of trade added about £200 millions to the United Kingdom's import bill in 1947 and about £100 millions in 1948. On the assumption that drawings on overseas credits to the United Kingdom (£868 millions in 1947 and £352 millions in 1948) would have been the same in the absence of repayment of sterling liabilities, these repayments had the same effect as a deterioration in the terms of trade of approximately 6 per cent in 1947 and 9 per cent in 1948. It would appear, therefore, that these unrequited exports almost doubled the deterioration in the terms of trade that would have occurred anyhow in 1947. In 1948, had there been no unrequited exports, there might have been a 4 per cent improvement in the terms of trade instead of a 5 per cent deterioration.

In 1949 the United Kingdom's external sterling liabilities to all countries remained fairly stable. The net change during the year was a decline of £3 millions.

In 1950 and 1951 there were no net unrequited exports. In 1950 the sterling balances rose throughout the year by £326 millions net. This represents unrequited imports. It means an accumulation of overseas claims on the United Kingdom economy. Funds enter the United Kingdom for which the United Kingdom does not give current goods or services in return. Repayment is postponed until the owners of these funds decide to withdraw them. In the meantime the United Kingdom can add these funds to her foreign exchange reserves or acquire current imports. Some will prefer to reserve the term 'unrequited imports' for the acquisition of goods that are not currently paid for. However, as the United Kingdom is free to decide what to do with these funds, it is legitimate to include the acquisition of currency.[3] In what follows, the term 'unrequited imports' will be used in this wider sense. Where reference is made to unrequited imports in the narrower sense they will be called 'unrequited imports of goods'.

Early in 1951 the increase in the sterling balances continued. During the first half of the year the sterling balances reached their highest figure to date. The peak appears to have been passed by 30th June 1951,

[1] cf. *Economic Survey for* 1949, Cmd. 7647, para. 57.
[2] op. cit., loc. cit.
[3] See also section 8.

when the balances stood at £4,168 millions — a net increase of £425 millions in six months. During the second half of 1951 the balances fell by £361 millions. Hence the net change for 1951 was still an increase of £64 millions.

In 1950 the net unrequited imports were equivalent to 14 per cent of the United Kingdom's imports of merchandise; in 1951, 2 per cent. If invisible imports are included, the percentages are 11 and 2 respectively. Had there been no unrequited imports, and all other items in the balance of payments are taken as given, then the balance of payments of the United Kingdom in 1950 would have shown a deficit of £82 millions, instead of a surplus of £244 millions. In 1951 the deficit would have been £585 millions instead of £521 millions. During 1950 the terms of trade deteriorated by 13 per cent.[1] This cost the United Kingdom about £300 millions.[2] The unrequited imports of £326 millions more than offset this. The British economy could carry on as if there had been a slight improvement in the terms of trade. During the first half of 1951 the terms of trade of the United Kingdom deteriorated by a further 12 per cent, at a cost of, probably, between £200 millions and £250 millions. This was more than offset by £425 millions of unrequited imports. During the second half of 1951 the United Kingdom's terms of trade improved by 12 per cent. Since trade was slightly larger during the second half of the year than during the first half, the United Kingdom gained slightly more from this improvement in the terms of trade than what she had lost earlier in the year. But during the second half of the year there were unrequited exports of £361 millions. The net result was that during the first half of the year, when the terms of trade deteriorated by 12 per cent, the United Kingdom fared as if the terms of trade had improved by a similar percentage. During the second half of the year, when her terms of trade improved by 12 per cent, she fared as if the terms of trade had deteriorated. For 1951, as a whole, the net result of the movement in the terms of trade and unrequited trade appears to have given the United Kingdom some relief, probably about £100 millions.

In 1950 and 1951, most of the unrequited imports were absorbed in the augmentation of the currency reserves. There were no substantial net unrequited imports of goods in either year, taking each

[1] cf. *Monthly Digest of Statistics*.

[2] Increase in import bill due to rise in prices £400 millions. (Source: *Economic Survey for* 1951, Cmd. 8195, para. 94). Increase in export receipts due to rise in prices £100 millions (source: *The Economist*, 13th January 1951, p. 94).

year as a whole. However, there were quite substantial unrequited imports of goods during the second half of 1950 (£75 millions) and the first half of 1951 (£145 millions). Net unrequited exports of goods during the remainder of those two years reduced the balance of net unrequited imports of goods to £8 millions in 1950 and £4 millions in 1951.[1]

None of these figures take account of unrequited imports financed out of North American grants and loans. In this section attention is confined to changes in unrequited trade resulting from changes in the sterling balances.

Unrequited imports in the form of increases in sterling balances make the United Kingdom liable for repayment to the owners of these balances. They are the potential unrequited exports of the future. In fact, debt repayments to some of the holders of sterling balances have been going on throughout the period under consideration. Sterling debts to some countries have been paid off or reduced. At the same time new debts were incurred to other countries. Thus the United Kingdom exchanged new creditors for old.

During the period under consideration, the largest single creditor was India. The new India's share of the Indian sterling balances came to about £800 millions in 1948. India's sterling balances fell from £771 millions at the end of 1948 to £603 millions in June 1950. They then rose to £663 millions on 31st March 1951. Afterwards they declined again to £643 millions in June 1951, and £570 millions on 8th February 1952.[2] These figures show considerable fluctuations,

[1] Calculated as follows:

| | 1950 | | 1951 | |
|---|---|---|---|---|
| | First Half | *Whole Year* | First Half | Second Half |
| | £ millions | | | |
| Change in Gold and Dollar Reserves .. | +262 | +575 | +203 | −547 |
| United Kingdom Balance of Payments plus gold settlements with E.P.U. .. .. | + 46 | +257 | − 77 | −767 |
| Difference .. .. .. .. .. | +216 | +318 | +280 | +220 |
| Deduct above *from* Unrequited Trade .. | +149 | +326 | +425 | −361 |
| Net Unrequited Imports of Goods (+) and Net Unrequited Exports of Goods (−) .. | − 67 | + 8 | +145 | −141 |

[2] Source: High Commission of India.

but the downward trend predominates. The progress in the settlement of the Indian balances is even greater than these figures suggest at first sight. In 1948 about £200 millions was considered necessary as normal currency reserve.[1] Early in 1952, £340 millions were held as currency reserve[2]. This reduces India's excess balances from about £600 millions in 1948 to £230 millions in February 1952.

Under the Colombo Plan India is to draw £210 millions between 1951 and 1957, and perhaps more, since provision is made for flexibility. The Indian Minister of Finance is reported to have said in autumn 1951: 'if conditions remain what they are, there will be nothing left of the sterling balances problem at the end of six years'.[3]

Whether conditions will remain 'what they are' will depend on how events during those six years will affect the value of sterling. The devaluation of the pound sterling in 1949 has belied the earlier estimate of the sterling balances India needs as a currency reserve. It has wiped out about £140 millions of India's excess balances. Should the international purchasing power of the pound sterling fall further, £340 millions would be inadequate as currency reserve. Let it not be supposed, however, that a further devaluation would be an easy way out of the sterling debt problem. Everything else apart, it would encourage India and other R.S.A. countries to seek another basis for their currency rather than the pound sterling. In such case even the present currency reserve might be presented for repayment, and the loss to the United Kingdom would outweigh the gain. Even now India is building up direct financial relationships with non-sterling countries. The Indian Reserve Bank is reported to have disclosed 'that between 1949-50 and 1950-1 the proportion of bills drawn or remittances received in hard currency countries of destination rose from 20 per cent to 40 per cent, while the use of sterling bills dropped from 62 per cent to 40 per cent'.[4] Such tendencies will be discouraged only if the pound sterling is strong. It must be regarded as certain that it will at least maintain its value. On this depends its usefulness as currency reserve. As Britain's debt to India is diminished, sterling becomes

[1] Indian Minister of Finance at a Press Conference, reported in *Keesing's Contemporary Archives*, 1948, Col. 9412.

[2] Exchange of letters between the Chancellor of the Exchequer and the Indian Minister of Finance, reported in *The Times*, 14th February 1952.

[3] *The Economist*, 27th October 1951, p. 1001.

[4] *The Economist*, 10th November 1951, p. 1145.

scarcer. It automatically hardens, provided its supply is not enlarged by increased indebtedness to other countries.

While the debt to India was scaled down during most of the period under consideration, the debt to other countries has increased. If the reduction of the debt to India is accompanied by more than compensating increases in sterling liabilities to other countries, say Australia, the United Kingdom simply exchanges one creditor for another and the United Kingdom's sterling debt problem is no nearer solution. In such case what happens is that Indian development is financed via Australian credits to the United Kingdom: India reduces her credits, Australia increases hers.

Australia was the second largest single sterling creditor to the United Kingdom during the period under consideration. Australia's sterling balances stood at £95 millions in mid-1945, at £172 millions in mid-1948, and at £418 millions towards the end of 1950. They reached their peak in June 1951, when they stood at £531 millions. This was followed by a rapid decline to 357 millions by December 1951[1]. Thus the United Kingdom received £436 millions of unrequited imports from Australia during the six years ending 30th June 1951 and gave £174 millions of unrequited exports to Australia during the six months ending 31st December 1951. Australia's withdrawals during the second half of 1951 were at about five times the average annual rate of the building up of her sterling balances during the previous six years, but only one-and-a-half times the rate of building up her sterling balances during the previous six months. Australia's withdrawals continued at a heavy rate early in 1952. At the beginning of March 1952 her balances stood at about £260 millions. The Australian Government feared that Australia's sterling balances would fall below £240 millions by June 1952, if no action were taken. They considered that such withdrawals of sterling balances would endanger Australia's currency reserves.[2] To prevent this they imposed heavy restrictions on imports from the United Kingdom and other countries that accepted payments in sterling. This action was widely regretted. But, to the extent to which the Australian import cuts prevented a further outflow of unrequited exports from the United Kingdom, inflationary pressure in the United Kingdom was reduced. To the extent to which this action

[1] Source: Commonwealth Bank of Australia: *Statistical Bulletin*. Figures converted into United Kingdom pound sterling.
[2] Prime Minister of Australia, as reported in *The Times*, 11th March 1952.

showed that at any rate one major country feared a scarcity of sterling funds, the value of the United Kingdom pound sterling was somewhat strengthened. As long as Australia considers a currency reserve of £240 millions the absolute minimum, the problem of the United Kingdom sterling debts to Australia is solved. It is not yet certain whether this will last. Before the war Australia's currency reserve was only about one-tenth of her present minimum requirements.

The solution of the problem of the Indian sterling balance will be reached by 1957, if conditions remain what they were towards the end of 1951. The problem of the Australian balance was 'solved' in a somewhat unexpected way early in 1952. As to the other independent R.S.A. countries: Ceylon and Pakistan, like India, plan to use up their excess balances by 1957 under the provisions of the Colombo Plan. The future of the balances of the other independent R.S.A. countries is less certain. The colonial balances rose steadily between 1945 and 1951: they stood at £447 millions at the end of 1945, £646 millions in mid-1950, £752 millions in December 1950, £908 millions in mid-1951 and £964 millions at the end of 1951. Owing to the continuous rise of the colonial balances throughout 1951, the total of the sterling balances was higher at the end of 1951 than at the beginning of the year. The principal non-R.S.A. holder of sterling balances is Egypt. Her balance stood at £230 millions at the beginning of 1951. Provision has been made for annual releases to reduce her balance to £80 millions by 1963. Egypt is likely to require this sum for currency and trade purposes.[1]

The position in 1951 is summarized in the table on the following page.

Sooner or later, the excess balances will have to be repaid. The problem of unrequited exports is always present while there are outstanding debts to be honoured. It is liable to become apparent at any time, should the sources of new credit dry up, e.g. if a slump occurs in the principal export trades of the creditors.

The insecurity is due to the fact that only a small fraction of the United Kingdom's external sterling liabilities is invested in long-term securities. The funds can be fairly quickly realized by their owners. Even where funding agreements exist, past experience suggests that the agreed releases can be easily overdrawn. The provision for flexibility

[1] cf. Statement of Financial Secretary to the Treasury in the House of Commons, 15th March 1951.

Sterling Balances in 1951

| | £ millions | | |
|---|---|---|---|
| | Change in First Half | Change in Second Half | Position at 31st December |
| Colonies .. .. .. .. | +154 | + 56 | 964 |
| India .. .. .. .. | + 24 | − 60 | 583[1] |
| Australia .. .. .. .. | +115 | −174 | 357 |
| Other R.S.A.[2,3] .. .. .. | + 75 | −128 | 885 |
| Non-R.S.A. .. .. .. | + 57 | − 50 | 1,018 |
| TOTAL .. .. .. .. | +425 | −361 | 3,807 |

in agreed releases to the countries covered by the Colombo Plan suggest that this might be expected to continue in the future.

The bulk of the sterling balances is held in the form of Treasury bills, bearing interest at ½ per cent between 1945 and 1951. In 1947 and 1948 this cost the United Kingdom about £10 millions a year in interest payments to holders. This was paid into holders' unrestricted accounts. It can be deduced that about £2,000 millions of the total sterling balances of approximately £3,500 was kept in the form of Treasury bills. The remainder included colonial sterling balances of over £500 millions in those years, of which a substantial proportion was held by the Crown Agents, currency boards and similar authorities in the form of short- and medium-term securities at varying higher rates of interest. The rest, approximately £1,000 millions, was kept in cash.[4] In so far as the position in 1947 and 1948 is a general guide to the

1 Estimated figure: Indian balances £643 millions on 30th June 1951 and £570 millions on 8th February 1952.

2 Estimated figure: Official figures minus above.

3 Other R.S.A. includes the holdings of Eire (£210 millions held by Irish Government, the Central Bank of Ireland, Irish commercial banks and Irish Courts), Pakistan (£146 millions in March 1952), New Zealand (£63 millions in December 1951), the Union of South Africa (£62 millions in November 1951), the capital value of payments due to India and Pakistan under the Pensions and Annuities Scheme of 1948 (£154 millions at the end of 1951), the central reserve holdings of Ceylon, Burma, Iceland, Iraq and Jordan, and balances held by official bodies other than the central reserve bank in any of the independent R.S.A. countries. (Sources: Cmd. 8505, Irish Embassy, and Dominion High Commissions.

4 H.C. DEBs., vol. 448, Col. 1877; vol. 453, Col. 1011-12; vol. 454, Col. 231.

forms in which the sterling balances are held, approximately 60 per cent are invested in Treasury bills, about 10 per cent in other British Government securities, the remaining 30 per cent in cash.

The Bank Rate was raised in November 1951 and March 1952. The immediate effect of a rise in Bank Rate is to lower the value of securities. Withdrawals of sterling balances held in the form of Treasury bills cost an unexpected high rate of discount. This applies only if the bills are discounted before their maturity date. Once the bills have matured and are exchanged for new ones, this cost factor to their owners disappears. This might encourage some postponement of withdrawals for periods up to three months after the raising of the Bank Rate, since Treasury bills mature after three months. Afterwards the owners gain. They buy more Treasury bills at a lower price each bill and receive higher interest. If the Bank Rate rises from 2 per cent to 4 per cent, and the discount rate on Treasury bills rises correspondingly from ½ per cent to approximately 2½ per cent, then interest payable on £2,000 millions of sterling balances rises from £10 millions a year to £50 millions a year. There is a cumulative increase in cost. If there are no withdrawals, then, after one year, 2½ per cent has to be paid on £2,050 millions instead of ½ per cent on £2,010 millions. It will be shown below that this increase in cost was not the only way in which the increase in the Bank Rate affected the sterling balance position.

Between 1945 and 1951 the increase in the amount of Treasury bills allotted to the holders of these sterling balances did not lead to a stringency in the supply of Treasury bills for the London clearing banks. The ratio of cash and money market assets (short-term securities)[1] to total bank assets used to be 30 per cent before the war. In 1951 this 'liquid assets ratio' was 45 per cent; if Treasury Deposit Receipts are excluded 41 per cent. Bills discounted alone were about 13 per cent of total bank assets before the war, but 20 per cent in 1951.[2] The absorption of over two-fifths of the total current supply of Treasury bills in sterling balance holdings was basically deflationary. It could only be regarded as a minor factor, while the general situation was strongly inflationary. Nevertheless it was not unimportant. By holding Treasury bills instead of cash, the holders of the sterling balances

[1] Money at call and short notice, bills discounted, and since the war also Treasury Deposit Receipts.

[2] cf. *Monthly Digest of Statistics.*

subscribed to the British Government's Floating Debt. During the first ten months of 1951 the Floating Debt averaged £5,962 millions, of which £5,262 millions was in Treasury bills.[1] The Government needs the Floating Debt to bridge the time-lag between its expenditure and receipts of revenue. Central Government expenditure in 1951 was £4,097 millions.[2] There was a considerable margin between the Government's current expenditure and the total supply of Treasury bills. Considerable fluctuations in sterling balances could take place without direct effects on the internal credit structure.

The raising of the Bank Rate in November 1951, together with the funding of part of the Floating Debt reduced the supply of Treasury bills by about £800 millions,[3] and the clearing banks' holdings of bills discounted (mostly Treasury bills) by about £500 millions.[4] On 31st March 1952 the Floating Debt stood at £4,273 millions. The Central Government budgeted for Ordinary Expenditure of £4,240 millions in 1952-3.[5] Should there be heavy withdrawals of sterling balances after March 1952, the internal credit structure may well be affected. Either the Floating Debt will have to be reduced to a figure below the Government's annual outlay, or the Government will have to borrow from the money market to replace borrowing from holders of sterling balances. Should there be withdrawals of sterling balances of, say, £500 millions, the Government may want to offer an equivalent amount to the banks. If the banks take it up, they restore their pre-November 1951 assets structure. This assumes that the reduction in Treasury bills discounted held by the banks will eventually be compensated by increases in cash and money at call or short notice rather than in investments and advances. After November 1951, the banks compensated the loss of Treasury bills by an increase in their investments and advances. In January 1951, investments and advances accounted for 61 per cent of total bank deposits, compared with 51 per cent a year earlier. The March 1952 increase in the Bank Rate is likely to curtail long-term borrowing from the banks, so that the ratio of investments and advances is likely to fall. The two increases

[1] op. cit.

[2] Cmd. 8486.

[3] Comparing position at 31st March 1951 and 31st March 1952. The March 1952 increase in Bank Rate led to no further reduction in the volume of Treasury bills in the market to date.

[4] Comparing November to January of 1950-1 and 1951-2.

[5] *Financial Statement*, 1952-3.

in the Bank Rate, together with the funding of part of the Floating Debt and curtailments in bank credit, leave it possible for the United Kingdom to face a withdrawal of sterling balances up to £500 millions with the probability of no further internal effects than the restoration of the pre-November 1951 credit structure. Other things being equal, any greater withdrawals of sterling balances might lead to difficulties for the banks or difficulties in the day-to-day finance of Government. Should there be an increase in sterling balances, the Government will be able to reduce internal borrowing correspondingly.

If the internal economy is isolated from the effects of movements in the sterling balances, as was the case before November 1951, these movements will affect the external value of the currency. The increase in sterling balances in 1950 must have played a considerable part in creating 'bull' conditions for sterling in foreign exchange markets. The demand of the R.S.A. for sterling funds raised the value of sterling securities. A decrease in sterling balances would lead to a corresponding 'bear' position, unless the home market can absorb the 'excess' Treasury bills without detrimental effects on the internal credit structure. Where the internal credit structure is considered more important than the external value of the currency, these 'bull' and 'bear' situations will be allowed to occur. Where the external value of the currency is considered as important as internal problems, the internal credit structure must be made sufficiently flexible to absorb the deflationary effects of rising sterling balances and the inflationary effects of falling sterling balances.

There is no danger of a sudden withdrawal of all of the excess sterling balances or even their conversion into cash holdings. The latter procedure would lose the holders any interest they earn by holding securities. In either case the result would be financial trouble in the United Kingdom and the sterling balances would become worthless. Clearly this is not in the interest of the creditors. Nevertheless, it is useful to realize the inflationary potential there is in these sterling balances. It is desirable to convince ourselves that it is no good advocating a slower release from the balances than the Treasury has been able to persuade creditors to accept. Quite apart from questions of commercial morality and considerations of our future credit-worthiness, any slackening of payments of agreed amounts could let loose inflationary tendencies if it encouraged an impatient creditor to take actions without regard to the consequences to the United Kingdom and

the ultimate value of his own balance. If creditors have in the past exceeded agreed withdrawals, efforts should be intensified to demonstrate to them that unduly speedy withdrawals that harm the United Kingdom economy undermine the value of the debts due to them and the value of all sterling currencies. There is no case for a blank refusal to honour any of the debts when recalled by the creditors, lest a saving of relatively little undermines confidence. The solution of the problem lies in the funding agreements that have been concluded with a large number of creditors and honourable discharge of the obligations assumed in these agreements by both sides. It might be worth considering whether the same effect could not be obtained if the owners of these debts could be persuaded to convert some of their holdings into long-term securities.

The problem is easier in boom than in slump. For example, in 1950 the net increase in sterling balances was largely the result of high raw material prices. R.S.A. countries benefited from the high prices, particularly in dollar markets. Their dollar earnings rose substantially. In fulfilment of their obligation as members of the sterling area they surrendered any dollars earned in excess of day-to-day requirements to the sterling area gold and dollar pool. In return they received sterling securities. In the second half of 1951 some raw material prices fell and with them the R.S.A.'s net contribution to the gold and dollar pool. Overseas sterling balance holders might well wish to withdraw funds at a faster rate in a slump than the rate at which they had earned [illegible] millions and £[illegible] millions from the balances should be reckoned with in a major depression year, given the 1951 level of the balances.

This problem must be faced. It is as important as any, if at a time of trade depression full employment in Great Britain can be maintained only by increased Government expenditure. This must be done without lowering the clearing banks' cash reserves below the present 8 per cent of total assets and without endangering confidence in the banks. It is as important a problem as any other that affects the external value of the pound sterling. It is not proposed to deal with these wider fiscal and monetary problems in this connection. Here it must suffice to point out how the sterling debts affect the position.

### 6. THE TERMS OF TRADE AND THE TRADE CYCLE

The last two sections were concerned with problems of the sterling area in the 1930's and '40's, excluding the war years. In neither of these two periods could the sterling area function without special complications. The monetary stock-piling of the R.S.A. in the 1930's, particularly the early '30's, had some deflationary effects on the United Kingdom economy. Since the war the sterling area system has been overshadowed by the problem of the United Kingdom's external sterling liabilities. These liabilities rose in 1946, 1950 and 1951, which meant net unrequited imports into the United Kingdom from holders of sterling liabilities with, in those years welcome, deflationary effects on the United Kingdom economy. The liabilities declined in 1947 and 1948, which meant net unrequited exports from the United Kingdom to her sterling creditors with corresponding inflationary effects on the United Kingdom economy. All the time the excess balances represent a potential inflationary pressure on the United Kingdom economy. These factors somewhat obscure some of the real benefits the sterling area system confers upon its members. In this and the following sections these benefits will be considered in more detail than has been done in previous sections.

One of the chief benefits of the sterling area system derives from the fact that it is a monetary union between the United Kingdom and economies that, on the whole, are complementary to the United Kingdom economy. The United Kingdom exports largely manufactures and imports food and raw materials. The R.S.A. as a whole is a net exporter of food and raw materials and a net importer of manufactures. The terms of trade move in favour of the United Kingdom if prices of manufactures rise relatively to prices of food and raw materials, and against the United Kingdom if prices of food and raw materials rise relatively to the price of manufactures. The terms of trade move in favour of the R.S.A. if primary product prices rise relatively to prices of manufactures and against the R.S.A. if the opposite happens. In short, the terms of trade of the United Kingdom and the terms of trade of the R.S.A. move in opposite directions. This fact is of the utmost importance in stabilizing the external value of the pound sterling and with it the external value of all R.S.A. currencies within the course of a trade cycle.

When the terms of trade move in our favour, we obtain the same quantity of imports as before for a smaller quantity of exports or a

larger quantity of imports for the same quantity of exports. There is a tendency for our economy to extend. The import-purchasing power of our currency rises, so that the international value of our currency increases. The opposite happens if the terms of trade move against us. In the absence of the sterling area monetary union there would be a tendency for the pound sterling to appreciate every time the terms of trade move in favour of the United Kingdom. There would be a tendency for the pound sterling to lose value every time the terms of trade move against the United Kingdom. Now, the terms of trade of the R.S.A. countries tend to move in the opposite direction to the terms of trade of the United Kingdom. In the absence of the sterling area system this would mean that every such appreciation of the United Kingdom pound due to a favourable movement in the terms of trade would be accompanied by a depreciation of R.S.A. currencies, because this movement in the terms of trade is unfavourable to them. Similarly, a tendency for the United Kingdom pound to lose value because of unfavourable movements in the terms of trade would lead to an appreciation of the currencies of R.S.A. countries to whom this movement in the terms of trade is favourable. Thus, in the absence of the sterling area system the United Kingdom would be better off and the R.S.A. worse off than they actually are when the terms of trade move in favour of the United Kingdom, while the opposite movement in the terms of trade would make the United Kingdom worse off and the R.S.A. countries better off than they are within the sterling area system, according to which of these two movements persists.

The terms of trade are subject to cyclical fluctuations. If the United Kingdom currency and the R.S.A. currencies were isolated currencies, there would be a strong tendency for cyclical fluctuations in the external value of each of the member currencies. This tendency could be counteracted through domestic inflationary and deflationary policies, but these are often very painful. A monetary union between complementary economies can have similar stabilizing effects on the external value of member currencies without the necessity of domestic credit fluctuations. Tne sterling area is just such a union. Despite all the factors that have impeded the free working of the sterling area system to the full benefit of its members, there is no doubt that it has been an important stabilizing factor. It has often been pointed out that sterling was one of the most stable currencies, if not the most stable currency, after 1931. It is still less liable to fluctuations than most

currencies. At least one of the reasons for this is that its external value is stabilized by this monetary union of complementary economies.

For these reasons the sterling area system can be described as a system of mutual insurance, between the United Kingdom and the R.S.A., against cyclical fluctuations in the external value of sterling. Whether the insurance premium is paid in boom or slump, and when the benefits are greatest or least, depends for each member on whether export prices fluctuate more or less than import prices.

It will be convenient to start with a simplified model. Assume (i) that the external trade of the United Kingdom and of the R.S.A. is of equal value; (ii) that prices of manufactures and prices of primary products fluctuate to the same extent, though in opposite directions. In this over-simplified model the United Kingdom gains as much during the 'manufacturing boom' as the R.S.A. loses, while the R.S.A. gains as much from the 'primary products boom' as the United Kingdom loses. Gain and loss exactly compensate. In case of a monetary union between the United Kingdom and the R.S.A., the United Kingdom transfers some of the benefits of the manufacturing boom to the R.S.A. by avoiding an appreciation of the United Kingdom currency and a depreciation of the R.S.A. currencies. The R.S.A. does the same for the United Kingdom in times of primary products boom, being on our assumptions coincident with a manufacturing slump. If our assumptions could be maintained, the conclusion would be that stability of the exchanges can be had within a trade cycle without one side gaining or sacrificing more than the other.

Assumption (ii) is untenable. In actual fact it is not the prices of manufactures and of primary products that move in opposite directions throughout the trade cycle, but the terms of trade, i.e. the ratio of manufacturing prices to primary product prices or *vice versa*. Manufacturing prices and primary product prices tend to move in the same direction. (Usually there is a time lag, with primary product prices leading both into and out of depressions. But let this be ignored for the moment). While manufacturing prices and primary product prices tend to move in the same direction, they tend to do so at an unequal rate. Suppose manufacturing prices fluctuate more than primary product prices. In this case the import-purchasing power of the United Kingdom currency is at its maximum in times of boom and at its minimum in times of depression, while the import-purchasing power of R.S.A. currencies is less in times of boom than in times of

depression, if there is no monetary union. Monetary union between the United Kingdom and the R.S.A. lowers the import-purchasing power of the United Kingdom currency in times of boom and raises it in depression, while the import-purchasing power of the R.S.A. currencies is raised in times of boom and lowered in times of depression. It remains true that the monetary union buys for its members stability of the exchanges. But it is not a matter of indifference whether the beneficial effects of this stability raise real incomes in times of boom or in times of depression. If it is true than an increase in real incomes is most desired in times of depression, then the sterling area benefits the United Kingdom more than it benefits the R.S.A. if prices of manufactures fluctuate more than prices of primary products. When fluctuations in primary product prices exceed fluctuations in manufacturing prices the position is reversed. In this case the monetary union raises the import-purchasing power of R.S.A. currencies in times of depression and lowers it in times of boom and conversely with the United Kingdom currency, so that the R.S.A. benefits more than the United Kingdom.

It is a somewhat hazardous task to estimate whether manufacturing prices will fluctuate more or less than primary product prices in future trade cycles. Between 1870 and 1939 there were eight cyclical slumps. In four of these the terms of trade of the United Kingdom improved[1], in the other four they deteriorated.[2,3] The slumps with improved terms of trade for the United Kingdom all occurred during periods of stagnation of world trade, i.e. in the 1880's and in the inter-war period. The four slumps that were accompanied by a deterioration of the terms of trade of the United Kingdom all occurred when world trade was expanding. During that period an expansion of world trade implied a secular increase in the demand for primary products. The long-term upward trend in demand for primary products was a check to downward fluctuations in primary product prices in times of cyclical slump. When world trade stagnates, primary product prices are no longer protected by a long-term upward trend in demand. There is then a tendency for raw material stocks to accumulate. Primary product prices fluctuate correspondingly more than in periods of trade expansion. The manufacturer, on the other hand, does

[1] 1884-5, 1920-1, 1929-31, 1937-8.

[2] 1872-4, 1890-3, 1899-1900, 1907-8.

[3] cf. W. A. Lewis and F. V. Meyer: 'The Effects of an Overseas Slump on the British Economy', *The Manchester School*, September 1949, p. 238.

not curtail output so much in cyclical slump when there is a long-term expansion of world trade as when world trade stagnates. Hence his prices fluctuate relatively more in times of long-term expansion of world trade. In so far as this past experience is any guide, we can reach the tentative conclusion that the sterling area monetary union will help the United Kingdom more than the R.S.A. in periods of expanding world trade, and will benefit the R.S.A. more than the United Kingdom in times of stagnation of world trade. The conclusion must be tentative, *inter alia* because monopolistic practices on the part of manufacturers and primary producers may well skew the picture. Nevertheless, there is at least a strong presumption that in the long period one of the principal advantages of the sterling area system will benefit the R.S.A. more than the United Kingdom. In other words, the advantages of stabilization of import-purchasing power accrue to primary producing countries in times of cyclical slump when world trade stagnates. That is just when it is most valuable.

Although a tentative conclusion has been reached before all our assumptions are discarded, it remains necessary to abandon all unrealistic premises and so fill in the gaps that are still left in the argument. For simplicity's sake it was assumed that import and export prices rise and fall together at all times. They usually do. However, at cyclical turning points the change in the movement of primary product prices normally precedes the change in the movement of manufacturing prices. The time lag is not always very long and sometimes not noticeable in annual statistics. All the same it is a usual phenomenon. At these turning points manufacturing and primary product prices for a short period move in opposite directions, as in the over-simplified model on page 64. It follows that a monetary union between complementary economies somewhat delays the effects of the cyclical downturn on the primary producer whose import-purchasing power per unit of currency is maintained, because the value of his currency is supported by the still rising prices the manufacturing members of the union can command. Manufacturing economies, however, will feel the first impacts of the depression a bit earlier than they would in monetary isolation. At the cyclical upturn the position is reversed: the import-purchasing power of the manufacturing members is somewhat raised before their own prices rise, while the primary producing members have to wait before the higher primary product prices can have full effects on the import-purchasing power

of their currencies. The result is, thus, a softening of the effects of the cyclical turning points of benefit to the primary producer during the early downturn of the cycle and to the manufacturer during the early upturn.

The last assumption to be dealt with is that the United Kingdom and the R.S.A. have an equal impact on world trade. This may be true at some points of time, but need not always be so. Countries' impact on world trade can be measured in terms of aggregate value of their trade or by their balance of payments. If value of trade is the criterion, then the R.S.A. (as at present defined), has been growing steadily relatively to the United Kingdom for a long time. Before the war the United Kingdom's trade was still of greater value than the combined R.S.A. trade. Now the position is reversed. However, neither in the 1930's nor in the first six post-war years was there an overwhelming preponderance of one side over the other. Moreover, in this connection, it is not so much the ratio of United Kingdom trade to R.S.A. trade as such that is of interest, but the ratio of trade in manufactures to trade in primary products. The United Kingdom also exports primary products (coal), though to a lesser extent than before the war. Some R.S.A. countries also export manufactures and to an increasing extent. Even if on balance the ratio of manufacturing exports from the sterling area to primary product exports from the sterling area has somewhat declined, in a very rough way it is still true that, for the sterling area as a whole, the trade in manufactures and the trade in primary products are sufficiently equal in importance so that neither side can dominate the other because of this monetary union. Hence the above analysis is applicable to the sterling area as at present constituted without modifications that would invalidate it.

It is useful, however, to examine these modifications, since it is by no means certain that the ratio of manufactures to primary products will be always approximately equal. At present the sterling area's primary products trade is in the ascendancy and may well continue to increase faster than the sterling area's trade in manufactures. In such case what happens to primary product prices is correspondingly more important in determining the external value of sterling than what happens to manufacturing prices. If world trade stagnates and primary product prices fluctuate more than manufacturing prices, the beneficial effects to the R.S.A. of monetary union with the United Kingdom in times of depression is reduced and its cost to the R.S.A.

in times of boom is less than is the case when the United Kingdom and the R.S.A. are of equal importance. For the United Kingdom the cost of the monetary union in depression is accentuated and the benefit in times of boom increased, if primary products are more important in sterling area trade than manufactures. On the other hand, if we anticipate a growth of world trade and with it greater fluctuations in manufacturing prices than of primary product prices, a preponderance of primary products in sterling area trade will mean for the R.S.A. that the cost of the monetary union in times of slump is reduced, and so will be the benefit in times of boom. For the United Kingdom the benefit in times of slump is increased and so will be the cost in times of boom.

If manufactures were more important than primary products in sterling area trade the position would then be as follows. On the assumption that world trade stagnates and primary product prices fluctuate more than manufacturing prices, the R.S.A. gains more in slump and loses more in boom from the monetary union than if manufactures and primary products are of equal importance, while the United Kingdom gains less in slump and loses less in boom. On the assumption that world trade expands and manufacturing prices fluctuate more than primary product prices, the R.S.A. gains more in boom and loses less in depression than if manufactures and primary products are of equal importance, while the United Kingdom loses less in boom and gains less in depression.

This argument can be summarized in the table on the following page.

The benefits of stabilizing the external value of member currencies through the monetary union of complementary economies are not evenly distributed unless members are indifferent to whether the advantage is greatest in boom or in slump. If an increase in import purchasing power is most desired in times of depression, the sterling area system is most valuable to the United Kingdom in situation 2 (*a*), where the United Kingdom is weaker than the R.S.A. and world trade is expanding, particularly during the early upturn of the trade cycle.[1] The sterling area system is most valuable to the R.S.A. in situation 3 (*b*), where the R.S.A. is weaker than the United Kingdom and world trade stagnates, particularly during the early downturn of the cycle.

Against these advantages must be set the costs. In situation 2 (*a*),

[1]See page 66.

| Assumptions | | Effects of Monetary Union on External Values of Currencies: United Kingdom | Effects of Monetary Union on External Values of Currencies: R.S.A. |
|---|---|---|---|
| 1 | Manufactures and primary products of equal importance | | |
| a | Fluctuations in manufacturing prices greater than fluctuations in primary product prices: | gains in depression<br>loses in boom | gains in boom<br>loses in depression |
| b | Fluctuations in primary product prices greater than fluctuations in manufacturing prices: | gains in boom<br>loses in depression | gains in depression<br>loses in boom |
| 2 | Primary products more important than manufactures; compared with (1) | | |
| a | Fluctuations in manufacturing prices greater than fluctuations in primary product prices: | gains more in depression<br>loses more in boom | gains less in boom<br>loses less in depression |
| b | Fluctuations in primary product prices greater than fluctuations in manufacturing prices: | gains more in boom<br>loses more in depression | gains less in depression<br>loses less in boom |
| 3 | Manufactures more important than primary products; compared with (1) | | |
| a | Fluctuations in manufacturing prices greater than fluctuations in primary product prices: | gains less in depression<br>loses less in boom | gains more in boom<br>loses more in depression |
| b | Fluctuations in primary product prices greater than fluctuations in manufacturing prices: | gains less in boom<br>loses less in depression | gains more in depression<br>loses more in boom |

the United Kingdom currency is overvalued. So are the R.S.A. currencies in situation 3 (*b*). Import-purchasing power is artificially raised, but the export trades of countries with overvalued currencies tend to find themselves in difficulties. Hence there is likely to be a reduction in employment in the countries with the overvalued currencies. This cost will be the greater in times of secular unemployment. Secular unemployment is more likely to persist in times of stagnation or contraction of world trade than in times of expansion of world trade. In the latter case there might even be a gain if the country concerned

is in a position of over-full employment. Hence any unfavourable effects on employment in the export trades are likely to hurt more in situation 3 (*b*) than in situation 2 (*a*). It does not follow, however, that because the real income effects are most valuable in situation 3 (*b*), and even more so than in situation 2 (*a*), that the costs in employment will be correspondingly greater in 3 (*b*) than in 2 (*a*). The point is often made that primary producers suffer from depression more in the form of reduced incomes than in the form of unemployment. If so, the previous conclusion is not invalidated, namely that the greatest benefits that can be derived from the stabilizing effects of the sterling area system are the benefits the R.S.A. derives in situation 3 (*b*).

This argument about the anti-cyclical effects of the sterling area system has proceeded on the basis of member countries' impact on world trade as measured by the aggregate value of their trade. An alternative approach to countries' impact on world trade is by studying their balance of payments. This will now be attempted.

### 7. THE STERLING AREA'S BALANCE OF PAYMENTS ON CURRENT ACCOUNT 1946–51[1]

The sterling area's balance of payments of current account between 1946 and 1951 is shown in Table 1 (page 72).

These figures suggest that the United Kingdom was strong *vis-à-vis* the R.S.A. and, in some years, Europe. The R.S.A., though weak *vis-à-vis* the United Kingdom, showed on the whole greater strength than the United Kingdom *vis-à-vis* the dollar area and, at any rate in two of the years shown, *vis-à-vis* Europe.

In fact, the United Kingdom's strength *vis-à-vis* the R.S.A. was less pronounced than these figures suggest. The balance of payments on current account does not take account of unrequited trade in the form of variations in sterling balances. The figures have to be adjusted, if it is desired to find out the 'unaided' or 'independent' contribution the United Kingdom and the R.S.A. made to the sterling area's aggregate balance of payments on current account. Unrequited imports into the United Kingdom from the R.S.A. are deducted from the United Kingdom balance of payments and added to the R.S.A. balance of payments; and *vice versa* for unrequited exports from the United Kingdom to the R.S.A. The results are as follows:

[1] All figures in this section taken, or estimated, from Cmd. 8201 and Cmd. 8505.

| | 1946 | 1947 | 1948 | 1949 | 1950 | 1951 |
|---|---|---|---|---|---|---|
| | £ millions | | | | | |
| United Kingdom .. | −307 | −416 | − 94 | + 17 | −135 | −578 |
| R.S.A. .. . .. | + 22 | −338 | −192 | −304 | +562 | −102 |
| TOTAL .. .. .. | −285 | −754 | −286 | −287 | +427 | −680 |

The adjustment is particularly large for 1950. The United Kingdom's surplus on the balance of payments on current account in that year was an 'aided' surplus. Had the United Kingdom received no short term credit from the R.S.A. there would have been no surplus, but a deficit. It should be noted that the adjustment in the 1950 figures is greater than the R.S.A.'s surplus on current account for that year. By granting credit of £379 millions to the United Kingdom, the R.S.A. countries kept their imports below their combined current balance of payments surplus (£183 millions). R.S.A. imports in 1950 were kept at a level as if the R.S.A. had had a deficit of £196 millions in that year. In no other year was the adjustment so marked. The R.S.A. was stronger than current account figures suggest also in 1948 and 1951. The United Kingdom's position *vis-à-vis* the R.S.A. was actually stronger than current account figures suggest in 1946, 1947 and 1949.

Owing to the sterling area mechanism, now complicated by the existence of excess sterling balances, the United Kingdom strengthened the R.S.A. in 1946, 1947 and 1949, but weakened the R.S.A. in the boom years 1948, 1950 and 1951 (taking each year as a whole). The United Kingdom was strengthened in 1948, 1950 and 1951, and weakened in 1946, 1947 and 1949. The period under review seems to correspond to situation 2 (*b*) in the previous section (p. 69). On the basis of the analysis there, the United Kingdom should have been the principal beneficiary of the sterling area system in the boom years. However, the extent of the United Kingdom's gain and the R.S.A.'s loss in 1950, and to a lesser extent in 1951, appear to have been greater than the gain and loss one would expect on purely cyclical grounds. The non-cyclical factors that were at work and helped to bring about the results of 1950 and 1951, will be dealt with in the next section.

Before this is done, it will be useful to estimate the United Kingdom's

**TABLE I**

## United Kingdom, R.S.A. and Total Sterling Area Balance of Payments on Current Account

| | 1946 | 1947 | 1948 | 1949 | 1950 | 1951 |
|---|---|---|---|---|---|---|
| | £ millions | | | | | |
| (A) UNITED KINGDOM[1] | | | | | | |
| With R.S.A. | − 39 | +102 | +232 | +266 | +234 | +239 |
| With Dollar Area | −330 | −571 | −263 | −307 | −107 | −446 |
| With O.E.E.C. countries | + 86 | − 7 | + 95 | − 4 | +127 | −186 |
| With other countries | − 53 | − 57 | − 81 | + 55 | − 5 | −120 |
| With I.M.F. and Bank[2] | − 8 | − 12 | − 9 | − 5 | − 5 | − 8 |
| TOTAL | −344 | −545 | − 26 | + 5 | +244 | −521 |
| R.S.A.[3] | | | | | | |
| With United Kingdom | + 39 | −102 | −232 | −266 | −234 | −239 |
| With Dollar Area | − 64 | −266 | − 77 | − 89 | +155 | + 86 |
| With O.E.E.C. countries } With other countries[4] | + 4 | + 82 | + 11 | +10 | +157 | + 21 |
| | | | | | + 5 | −105 |
| With I.M.F and Bank | − 2 | − 7 | − 17 | − 15 | — | — |
| Gold Sales to the United Kingdom[5] | + 82 | + 84 | + 55 | + 68 | +100 | + 78 |
| TOTAL | + 59 | −209 | −260 | −292 | +183 | −159 |
| (C) TOTAL STERLING AREA [(A) + (B)] | | | | | | |
| With United Kingdom | + 39 | −102 | −232 | −266 | −234 | −239 |
| With R.S.A. | − 39 | +102 | +232 | +266 | +234 | +239 |
| With Dollar Area | −394 | −837 | −340 | −396 | + 48 | −360 |
| With O.E.E.C. countries } With other countries | + 37 | + 18 | + 25 | +61 | +284 | −165 |
| | | | | | 0 | −225 |
| With I.M.F. and Bank | − 10 | − 19 | − 26 | − 20 | − 5 | − 8 |
| Gold Sales to the United Kingdom | + 82 | + 84 | + 55 | + 68 | +100 | + 78 |
| GRAND TOTAL | −285 | −754 | −286 | −287 | +427 | −680 |

[1] Cmd. 8201 and Cmd. 8505, Table 2.
[2] International Monetary Fund and Bank for International Settlement.
[3] Cmd. 8201, Tables 2, 9-13; Cmd. 8505, Tables 2, 5, 8, 9, 11, 13.
[4] Estimated figures. Examples of estimates:

| | 1950 | 1951 | Source in Cmd. 8505 |
|---|---|---|---|
| Sterling Area *Net* Gold and Dollar Surplus or Deficit | +287 | -416 | Table 10 |
| Deduct U.K. current balance of payments | - (+244) | - (-521) | Table 1 |
| Deduct R.S.A. current balance of payments as shown in other items | - (+176) | - (+ 54) | Tables 2, 9, 11 and Cmd. 8201, Tables 10, 12 |
| Deduct U.K. gold movements with E.P.U. | - (+ 16) | - (-281) | Table 13 |
| Add Total Sterling Area gold movements with E.P.U. | + (+ 5) | + (- 5) | Table 11 |
| Add U.K. investments in R.S.A. | + (+149) | + (+130) | Tables 5 and 8 |
| | + 5 | - 105 | |

[5] 'Gold Sales to the United Kingdom, are a capital item as far as the United Kingdom is concerned, but a current account item for the gold producing R.S.A. countries.

and the R.S.A.'s 'independent' contributions to the sterling area's balance of payments by deducting all outside assistance from the figures. The adjustments made above showed the relative strength of the United Kingdom in truer perspective than the unadjusted balance of payments figures. Yet they are not the full story. There was other unrequited trade as well. During those six years the United Kingdom received long-term loans and grants of £2,178 millions[1], the R.S.A. £78 millions[2]. In addition, the United Kingdom received £193 millions net in credits from the European Payments Union and there was some unrequited trade affecting the sterling balances of some R.S.A. countries. True, the R.S.A. would not have received such aid. North American and other aid received by the United Kingdom was a contribution to the sterling area *via* the United Kingdom, though not by the United Kingdom. Nevertheless, if we want to know the independent contribution the United Kingdom and the R.S.A. made to the sterling area's balance of payments, the figures have to be further adjusted. The following shows the 'independent balance of payments' of the United Kingdom and the R.S.A. as well as other countries' contribution to the sterling area's balance of payments on current account:

| | 1946 | 1947 | 1948 | 1949 | 1950 | 1951 |
|---|---|---|---|---|---|---|
| | £ millions | | | | | |
| United Kingdom .. | −656 | −1,293 | −194 | −337 | −262 | − 929 |
| R.S.A. .. .. | + 22 | − 338 | −209 | −337 | +542 | − 110 |
| Total Sterling Area .. | −634 | −1,631 | −403 | −674 | +280 | −1,039 |
| Short-Term Loans received from (+), or granted to (−), Other Countries .. | + 70 | + 5 | −251 | + 9 | − 53 | + 7 |
| Grants and Long Term Loans received (+) from Other Countries | +279 | +872 | +368 | +378 | +288 | + 71 |
| E.P.U. Credits received (+) or given (−) .. | — | — | — | — | − 88 | +281 |
| Total Other Countries | +349 | +877 | +117 | +387 | +147 | +359 |
| GRAND TOTAL .. | −285 | −754 | −286 | −287 | +427 | −680 |

[1] United States Credit £930 millions, Marshall Aid £796 millions, Canadian Credit £297 millions, South African Loan £80 millions, and drawings on the International Monetary Fund £75 millions. The South African loan is included here; though a loan from a R.S.A. country, it did not affect the sterling balances position.

[2] Marshall Aid to Eire £46 millions, drawings on International Monetary Fund £32 millions.

These figures somewhat exaggerate the weakness of the United Kingdom in the earlier years. There were unrequited exports of goods from the United Kingdom of £431 millions in 1946, £91 millions in 1947, and £154 millions in 1948.[1] Of these £508 millions were gifts of the United Kingdom to United Nations organizations and foreign countries for post-war relief[2], mostly in 1946 and 1947. Of the remaining £168 millions most is due to the reduction of the United Kingdom sterling debt to Argentina in 1948. This, however, is shown in the figures. It was the principal factor in the reduction of the United Kingdom sterling debt to non-R.S.A. countries in that year. The debt to Argentina was reduced by the sale of British railways in the Argentine and other overseas investment (£150 millions in 1948) and net unrequited exports to Argentina (£16 millions) under the terms of the Andes Agreement between the United Kingdom and Argentina.[3]

Even if it is considered legitimate to adjust the figures to allow for these factors, the United Kingdom's independent balance was in deficit throughout. The best year was 1948. If allowance is made for unrequited trade in goods in that year, the United Kingdom's 'independent deficit' was only £26 millions. This is equivalent to her deficit on the balance of payments on current account. By 1948, post-war reconstruction in the United Kingdom had made good progress. It was before the trade recession of 1949, and before the difficulties created by the Korean war and intensified rearmament.

In 1946, 1947, 1950 and 1951 the R.S.A. was stronger (or less weak) on independent account than the United Kingdom. In 1948 the United Kingdom was stronger than the R.S.A. In 1949, the United Kingdom and the R.S.A. were of exactly equal strength (or weakness). For the period as a whole, the United Kingdom economy was the chief source of weakness of the sterling area. But the R.S.A. too was in deficit in most years. The sterling area monetary union can smooth out the effects of trade fluctuations on the exchange value of the currency. It cannot be expected to solve long-term structural problems affecting any one member.

## 8. THE STERLING AREA GOLD AND DOLLAR POOL

The mechanism by which the R.S.A. increases its London sterling

[1] For method of calculation see p. 53.
[2] H.C. DEBs., vol. 494, col. 289–91.
[3] Cmd. 7648, pp. 10–11.

assets is as follows. When any member of the sterling area in its current transactions acquires gold or dollars or other foreign exchange that is convertible into gold, the proceeds are handed over to the sterling area's Gold and Dollar Pool. The Pool is administered by the Exchange Equalization Account. R.S.A. countries keep such foreign exchange earnings as they require for day-to-day transactions. But all foreign exchange earnings in excess of day-to-day requirements are handed over to the Exchange Equalization Account, in exchange for sterling securities. These sterling securities are depositited by their owners with the Bank of England. Similarly, if R.S.A. countries sell gold to the United Kingdom they receive sterling securities in exchange.

If a member wishes to withdraw funds from the joint Gold and Dollar Pool he sells sterling securities to the Exchange Equalization Account. There are few formal agreements that regulate members' withdrawals from the Pool. Apart from formal agreements with the Union of South Africa[1] and Iraq[2], restraint is exercised by a 'common understanding . . . to put in as much as possible and take out as little as possible'.[3] The Commonwealth Finance Ministers' decision in 1949 to cut dollar imports into the sterling area by 25 per cent was a gentlemen's agreement and not a formal treaty. Again, the Commonwealth Finance Ministers' Conference of 1952 reached informal understandings on how to cope with the balance of payments problems of the sterling area and its members, but no formal treaty was concluded. Indirectly, however, restraint is exercised also through the various funding agreements which limit withdrawals of sterling balances from restricted account.[4]

An attempt will be made to show the relative importance of movements in the sterling balances and other capital movements. Table 2 (p. 76), shows the contributions made by the United Kingdom, the R.S.A. and external aid to the sterling area's gold and dollar reserves in the post-war years. Figures for 1949 are omitted, since the devaluation of sterling in that year makes it impossible to compare the value of the gold and dollar reserves at the beginning and the end of the year.

The final result is shown in items 8, 9 and 10, showing the sources of replenishments and depletions of the Pool. The figures are arrived at in the way indicated in Table 2 and the notes on Table 2.

[1] Cmd. 7230.
[2] Cmd. 7201.
[3] Sir Stafford Cripps, see H.C. DEBs., vol. 446, col. 255.
[4] See p. 49.

TABLE 2

## Contributions of the United Kingdom, the R.S.A. and other Countries to the Sterling Area Gold and Dollar Pool[1]

| | | 1946 | 1947 | 1948 | 1950 | 1951 |
|---|---|---|---|---|---|---|
| | | £ Millions | | | | |
| 1 | Increase (+) or decrease (−) in Sterling Area Gold and Dollar Pool .. .. | + 54 | −152 | − 54 | +576 | −344 |
| 2 | United Kingdom balance of payments on current account .. .. .. | −344 | −545 | − 26 | +244 | −521 |
| 3 | R.S.A. balance of payments on current account .. .. .. .. | + 59 | −209 | −260 | +183 | −159 |
| 4 | Net capital movements [1 −(2+3)] .. | +339 | +602 | +232 | +149 | +336 |
| 5 a | Long term loans and grants to the United Kingdom and the R.S.A. .. .. | +279 | +872 | +288 | +288 | + 71 |
| b | South African gold loan to the United Kingdom .. .. .. .. | — | — | + 80 | — | — |
| c | Gold transactions with E.P.U. .. .. | — | — | — | + 13 | − 74 |
| 6 | Increase (+) or decrease (−) in Sterling Balances | | | | | |
| a | R.S.A. .. .. .. .. .. .. | − 37 | −129 | + 68 | +379 | + 57 |
| b | Other Countries .. .. .. .. | + 70 | + 5 | −251 | − 53 | + 7 |
| 7 | R.S.A. contribution on capital account [4−(5a+5c+6b)] .. .. .. | − 10 | −275 | +195 | − 99 | +332 |
| 8 | R.S.A. CONTRIBUTION | | | | | |
| a | Current Account (3) .. .. .. | + 59 | −209 | −260 | +183 | −159 |
| b | Excess accumulation (+) or withdrawals (−) of Sterling Balances (6a−3) .. | − 96 | + 80 | +328 | +196 | +216 |
| c | Sterling Balance Account [(8a+8b) or 6a] | − 37 | −129 | + 68 | +379 | + 57 |
| d | Other gross capital movements (7−6a) | + 27 | −146 | +127 | −478 | +275 |
| e | Accommodating capital movements (3 with signs reversed) .. .. .. | − 59 | +209 | +260 | −183 | +159 |
| f | Net capital movements, excluding Sterling Balances (8d−8e) .. .. | + 86 | −355 | −133 | −295 | +116 |
| g | TOTAL [(8c+8f) or (3+7)] .. .. | + 49 | −484 | − 65 | + 84 | +173 |
| 9 | OTHER COUNTRIES' CONTRIBUTION | | | | | |
| a | Sterling Balance Account (6b) .. .. | + 70 | + 5 | −251 | − 53 | + 7 |
| b | Other Capital Movements (5a+5c) .. | +279 | +872 | +288 | +301 | − 3 |
| c | TOTAL [(9a+9b) or (4−7)] .. .. | +349 | +877 | + 37 | +248 | + 4 |
| 10 | UNITED KINGDOM CONTRIBUTION (2) .. .. .. .. | −344 | −545 | − 26 | +244 | −521 |
| 11 | GRAND TOTAL [(8+9+10) or (1)] .. | + 54 | −152 | − 54 | +576 | −344 |

[1] Figures taken, or calculated, from Cmd. 8201 and Cmd. 8505.

NOTES ON TABLE 2

*Item* 4 shows movements in the Gold and Dollar Pool that are not accounted for in *items* 2 *and* 3. All changes in the Pool that are not accounted for by current transactions must be capital movements. They are net capital movements, because they exclude any capital movements required to accommodate the sterling area's balance of payments surplus or deficit on current account.

*Item 5a* includes loans and grants from the United States and Canada and drawings on the International Monetary Funds. The figures are totals of the aid received by the United Kingdom and the R.S.A. Since comparable annual figures are not available, no allowance could be made for United Kingdom gifts for post-war relief, amounting to approximately £500 millions since the end of the war.[1]

*Item 5c* shows gold transactions with the European Payments Union. In addition to these gold transactions, the United Kingdom gave credit of £88 millions to E.P.U. in 1950 and received credit of £281 millions from E.P.U. in 1951. These credit transactions reduce or augment the current supply of international means of payment at the disposal of the sterling area. But they do not directly alter the size of the Pool. Credits granted by the United Kingdom to E.P.U. may increase the demands on the Pool, credits received by the United Kingdom from E.P.U. protect the Pool, but they do not directly affect it. Hence credit transactions with E.P.U. are excluded from the table.

*Item 6b* excludes sterling liabilities in respect of sterling area countries' subscriptions to the International Monetary Fund and the International Bank for Reconstruction and Development. These were once and for all payments in 1946 (£26 millions) and 1947 (£362 millions). Since then variations in the sterling value of the subscription were due to revaluation in 1949 and occasional drawings. The effects of the latter are included under *item 5a*.

*Item* 7 shows the contribution the R.S.A. made to the Pool in addition to its current account surpluses or deficits.

*Item* 8 analyses the R.S.A.'s contribution to the Pool.

*Item 8b* shows the difference between changes in the sterling balances held by R.S.A. countries and the current balance of payments surplus or deficit of the R.S.A. If the sterling balances held by the R.S.A. fall when the R.S.A. has a surplus on its current balance of payments (1946, 1951), there appears to be a flow of capital on sterling balance account from the United Kingdom to the R.S.A. When the sterling balances held by the R.S.A. fall by less than the R.S.A.'s deficit on current account (1947), or rise while the R.S.A. has a deficit on current account (1948), or rise by more than the R.S.A.'s current surplus (1950), there is a flow of capital on sterling balance account from the

[1] H.C. DEBs., vol. 494, col. *289–91*.

R.S.A. to the United Kingdom. In the former case (flow of capital from United Kingdom to R.S.A.) there is less certainty than in the latter, since R.S.A. countries keep some of their exchange earnings for day-to-day requirements according to their own interpretations of what these are. It has been shown above (p. 54) that *e.g.* India retains an increasing proportion of her foreign exchange earnings.

*Item* 8*d* is a balancing item. It has no significance by itself, except to be the figure from which item 8*e* has to be subtracted to obtain the net capital movements not yet accounted for.

*Item* 8*e* represents the capital movements that accommodate the current balance of payments surplus or deficit. Every surplus on the balance of payments on current account is accommodated by an import of securities; every deficit on the balance of payments on current account is accommodated by an export of securities. The only exception is when goods are given away as gifts. These accommodating capital movements have to be deducted from the gross capital movements (8*d*) to show the genuine movement of capital (8*f*).

*Item* 8*f*. See notes on 8*d* and 8*e*.

*Item* 9 shows other countries' contributions to the Pool on capital account. Since these countries are not members of the Pool, their current transactions do not affect the Pool, unless they are transactions with the sterling area. Other countries' current transactions with the sterling area are accounted for by items 8*a* and 10. (If these two items are added together, intra-sterling area balances of payments cancel out.)

*Item* 10 shows the United Kingdom contribution. It shows the balance of payments on current account only. All capital transactions are accounted for in *items* 8 *and* 9.

Table 2 is drawn up on the assumption that a balance of payments surplus necessarily represents foreign exchange earnings that can be converted into gold. In present circumstances this need not always be true. For example, the United Kingdom did not directly contribute £244 millions to the Gold and Dollar Pool in 1950. Most of this surplus was with the R.S.A. (£234 millions) so that the United Kingdom's direct net contribution to the Pool was at best £10 millions. Nevertheless it is justifiable to regard any United Kingdom surplus on the balance of payments on current account as a contribution to the Pool, however indirect, if this surplus is due to a surplus with the R.S.A. A United Kingdom surplus with the R.S.A. correspondingly reduced the United Kingdom's liabilities. Moreover, the whole sterling

area system relies on R.S.A. countries earning dollars in exchange for which the United Kingdom supplies goods. Once the United Kingdom cannot export enough to meet R.S.A. requirements in exchange for R.S.A.-earned foreign currencies, it is doubtful whether the R.S.A. will continue the sterling area system. Exports to the R.S.A. are the United Kingdom's chief access to dollar goods.

If this argument be doubted, the adjustments in the figures can be made by deducting intra-sterling area trade from the current balance of payments figures. The relative position of the United Kingdom becomes relatively weaker, that of the R.S.A. relatively stronger. Figures for 'Other Countries' and the 'Totals' are unaffected by this adjustment. The results are:

| | 1946 | 1947 | 1948 | 1950 | 1951 |
|---|---|---|---|---|---|
| | £ millions | | | | |
| United Kingdom .. .. .. | −305 | −647 | −258 | + 10 | −760 |
| R.S.A. .. .. .. .. | + 10 | −382 | +167 | +318 | +412 |

These figures show that the United Kingdom export surplus with the R.S.A. must be regarded as a United Kingdom contribution to the Pool. However great the United Kingdom's difficulties were during the period under review, she did not live on foreign aid alone. In international trade, the United Kingdom's chief contribution to her own and the R.S.A.'s prosperity lay in her exports to the R.S.A.

True, in some years the United Kingdom deficit with other countries so reduced the United Kingdom's net earnings, that she withdrew more from the Pool than she put in as a result of her commercial transactions. But without her surplus with the R.S.A. in 1947, 1948 and 1951, the United Kingdom drain on the Pool would have been substantially larger.

The effects of capital movements on the Pool are shown in items 8 and 9 of Table 2. On capital account the chief contribution to the Pool came from the R.S.A. in 1951, from Other Countries in the other years shown.

In relation with Other Countries the exchange controls of the

sterling area countries prevented any substantial net flows of private capital[1]. Until 1950 there were substantial inflows of North American Government capital. Without these loans and grants the Pool would have been completely exhausted in 1947. In September 1949 the Pool had fallen to £330 millions. If at that figure devaluation cannot be avoided, then North American Government loans and grants prevented devaluation in 1946, 1947 and 1948. In 1950 these loans and grants doubled the strength of the United Kingdom. If such aid had been continued on the previous scale in 1951, the depletion of the Pool in that year would have been inconsiderable, or at any rate less than in 1947. This can be seen if the figures in Table 2 are compared with the actual size of the Pool at the end of each year:[2]

| | 1945 | 1946 | 1947 | 1948 | 1949 | 1950 | 1951 |
|---|---|---|---|---|---|---|---|
| £ millions .. | 610 | 664 | 512 | 457 | 603 | 1,178 | 834 |

The most substantial movement in Other Countries' sterling balance holdings occurred in 1948. It was due to reductions in the United Kingdom sterling debt to non-R.S.A. countries, principally Argentina.[3] Other Countries cannot contribute on current account: non-members put nothing into the Pool as a result of their current transactions, nor have they any claims on the Pool to finance their deficits. Their current trade with sterling area countries affects the Pool only *via* the current balances of payments of the United Kingdom and the R.S.A.

R.S.A. countries contribute to the Pool both on current account and on capital account. Some of their transactions are reflected in changes in their sterling balances, and some in other capital movements.

[1] Regarding inter-area transfers 'Each debit transaction is balanced by a credit transaction with a different area' (Cmd. 8505, p. 31). This suggests that there were no substantial direct net flows of private capital between the United Kingdom and the outside world. But there were flows of capital *via* the R.S.A. Hence all private capital movements are attributed to the R.S.A.

[2] Cmd. 8201 and Cmd. 8505. Figures from 1949 onwards in devalued currency.

[3] See p. 74.

The R.S.A.'s current balance of payments shows the net earnings of currency of the R.S.A. from its current commercial transactions. Since the R.S.A. countries keep their currency reserves largely in the form of sterling balances, the sterling balance position will be affected (8 *a*, *b*, and *c* in Table 2).

The R.S.A.'s sterling balances rise if the R.S.A. earns more foreign exchange than it spends. They will not necessarily rise to the full extent of the R.S.A.'s foreign exchange earnings, because some foreign exchange is retained for day-to-day requirements. How much exactly will be retained will vary from country to country and from time to time. On the whole, most of the fluctuations in the R.S.A.'s exchange earnings is likely to be reflected in fluctuations in sterling balances rather than in fluctuations of other currency holdings. If we are concerned with annual changes, rather than with absolute quantities at any one time, it can be assumed that changes in foreign exchange earnings are reflected in movements of the sterling balances. Any increase in sterling balances, due to this cause, means an unrequited import of currency into the United Kingdom.

The R.S.A.'s sterling balances rise also if the R.S.A. has a balance of payments surplus with the United Kingdom. This was of great importance during the war and still affected the position in 1946. In this case there were unrequited imports of goods into the United Kingdom.

The R.S.A.'s sterling balances fall if the R.S.A. spends more foreign exchange than it earns. In this case there is a direct withdrawal of funds from the Pool, in the manner described at the beginning of this section.

The R.S.A.'s sterling balances fall also if the R.S.A. has an unfavourable balance of payments with the United Kingdom. If the R.S.A. deficit with the United Kingdom is financed out of the R.S.A.'s London balances, there are unrequited exports of goods and services from the United Kingdom. The United Kingdom pays the R.S.A. in goods and services for former unrequited imports of currency or goods and services. There is a redistribution of claims on the Pool in favour of the United Kingdom. Nevertheless, even in this case there is a withdrawal from the Pool: the United Kingdom either exports goods and services to the R.S.A. which otherwise might have been exported to foreign currency areas; or, should the United Kingdom be unable to deliver the goods, there will be direct withdrawals from the Pool.

The R.S.A.'s sterling balances can be reduced also if there is a transfer of resources from the United Kingdom to the R.S.A. This can take the form of disinvestment: e.g. the transfer of ownership of United Kingdom investments in R.S.A. countries to these countries in exchange for a reduction in United Kingdom sterling debts. It can take the form of apparent investment: e.g. the United Kingdom 'invests' in South-East Asia under the terms of the Colombo Plan. But to the extent to which such 'investment' is financed out of sterling balances, there is a United Kingdom disinvestment of United Kingdom resources. This is so whether the resources were originally located in the R.S.A. or in the United Kingdom.

It is impossible to distinguish the changes in the sterling liabilities that were due to each of these causes. Hence the figures in Table 2 are aggregates. Any movement in sterling balances up to the total R.S.A. current account surplus or deficit can be regarded as the direct result of the sterling area mechanism, whereby R.S.A. countries keep their foreign exchange holdings in the form of sterling securities (8*a*). Capital movements in excess of these (8*b* and 8*f*) are facilitated by the relative freedom of capital movements within the sterling area.

Some of these 'excess' capital movements affect the sterling balances (8*b*). These are the hoardings or dishoardings of currency in excess of the direct results of current transactions. Excess hoardings can occur as a result of the transfer of local currency reserves to the Pool. More frequently the cause is stringent exchange control. Where the exchange controls do not allow member countries to spend as much foreign exchange as they earn, and the United Kingdom cannot fill the gap, there will be an excess accumulation of currency reserves. Excess hoardings can be due also to a genuine desire to augment the currency reserves. However, in a period when the existing balances were above currency requirements, the last-mentioned factor cannot have been of great importance. Excess dishoardings mean over-spending. Excess dishoardings occurred in 1946. In the other years shown there were excess hoardings (8*b*). More than half of these excess hoardings were used up to finance current deficits later in the same year or in later years. Gross currency hoardings in the five years shown totalled £724 millions (8*b*). Of this, £386 millions were used to finance current deficits (8*a*). Hence net currency hoardings were £338 millions (8*c*).

The remaining capital movements were due to a variety of factors.

They include genuine investment activities, receipts from past investments and speculative capital movements.[1]

On total capital account (7), the R.S.A. was a source of weakness to the Pool in 1947 and 1950. In the former year there was a substantial capital flight from the United Kingdom. Owing to the exchange regulations of the time most of this went to the R.S.A., although some of it may well have escaped the sterling area altogether during the convertibility crisis of that year. The capital export of 1950 is more likely to have been due to United Kingdom capital moving to the R.S.A. in search of profit, and some R.S.A. capital withdrawals from the United Kingdom, at a time of high raw material prices and profits in the R.S.A. The R.S.A. was a source of strength to the Pool in 1948 and 1951. In both years the chief cause would appear to have been currency hoardings. In 1951 other capital movements were also important. This may well have been due to capital leaving the R.S.A. during the second half of 1951, when raw material prices and profits were declining in some R.S.A. countries.

The net effect of the R.S.A.'s current and capital transactions combined (8*g*) was that the R.S.A. was a source of strength to the Pool in 1946, 1950 and 1951. It was a source of weakness in 1947 and 1948.

In 1946 and 1950 the R.S.A. was a source of strength because of its current account; in 1951 because of its capital account. In 1948 the R.S.A. was a source of weakness because of its current account; in 1947 on both accounts.

Hence the strength of the Pool depends on the balance of payments surplus of the United Kingdom; on the balance of payments surplus of the R.S.A.; and on the flow of funds from the R.S.A. to the United Kingdom, the administrator of the Pool. The last-mentioned movement depends on the R.S.A.'s balance of payments surplus with the

[1] The figures in item 8*f* can be split up as follows:

| | 1946 | 1947 | 1948 | 1950 | 1951 |
|---|---|---|---|---|---|
| | £ millions | | | | |
| United Kingdom investment (−) or disinvestment (+) in R.S.A. .. .. | + 60 | −270 | −149 | −149 | −130 |
| Other transfers .. .. .. .. | + 26 | − 85 | + 16 | −146 | +246 |
| Net capital movements, excluding sterling balances (8*f*) .. .. .. .. | + 86 | −355 | −133 | −295 | +116 |

outside world, on the R.S.A.'s balance of payments deficit with the United Kingdom, and on capital movements (see Tables 1 and 2).

The Pool has become the centre of the sterling area system. For it is the Pool that gives members access to generally acceptable international means of payment, sometimes in excess of current earnings. Countries that have not got unrestricted access to the Pool, i.e. the Union of South Africa and Iraq[1], cannot be regarded as full members of the sterling area. But even for them the Pool is of importance. For the size of the Pool determines the external viability of sterling.

When the size of the Pool rose after devaluation from £479 millions (devalued currency) on 18th September 1949 to £1,381 millions on 30th June 1951, sterling seemed so strong that there was a widespread belief in the possibility of an early up-valuation of sterling. During the subsequent nine months the Pool fell to £607 millions on 31st March 1952. If the value of the pound sterling were allowed to fluctuate freely, it would have risen in value during the former period and fallen in the latter.

Much has been written lately on the desirability of upvaluing sterling. It will be useful to examine the probable effects on the Pool, if such a policy were adopted. It is necessary to distinguish between effects on current account contributions to the Pool and on capital account contributions to the Pool.

The current account will be dealt with first. If sterling were upvalued, the terms of trade of the sterling area would improve. Provided there were no adverse effects on quantities exported, the balance of payments position would improve. Can it be assumed that there would be no adverse effects on quantities?

Suppose sterling were upvalued during a slump in world trade. Upvaluation would then come at a period when in its absence the position is likely to be as follows. In times of world slump the current account contributions to the Pool are endangered, if the sterling area's balance of trade with the dollar area deteriorates. This would lead to more than usual demands on the Pool both by the United Kingdom and the R.S.A., since the Pool alone can provide the means of payment for purchases in the dollar area in excess of current earnings. Unfortunately, this is almost certain, should a world slump occur now. In a world-wide slump the United States and Canadian demand for United Kingdom manufactures can be expected to fall more than the

[1] See p. 75.

United Kingdom demand for North American wheat, tobacco and cotton. Wheat is protected from substantial cyclical price variations by the International Wheat Agreement, and American tobacco and cotton are similarly protected by United States price support schemes. None of the primary products the R.S.A. exports to the United States and Canada is similarly protected from a price fall in slump. Unless the fall in North American manufacturing prices were sufficiently great to offset the relative stability of wheat, tobacco and cotton prices, the terms of trade with the dollar area must deteriorate in a slump. If, however, North American manufacturing prices fell sufficiently to maintain the sterling area's terms of trade with the dollar area, there would be a relative increase in demand for North American manufactures, unless United Kingdom and continental manufacturing prices fell correspondingly. In either case there would be abnormal demands on the Pool. In such conditions, the case for upvaluing sterling depends on the relative importance of the sterling area's imports of wheat, cotton and tobacco to the other trade of the sterling area. If there is no upvaluation of sterling in such a slump, the terms of trade of the sterling area with the dollar area will deteriorate. If sterling is upvalued in such a slump, United Kingdom manufacturing exports are likely to be adversely affected; since it would hardly be feasible in such circumstances to raise raw material prices against the dollar area, the balance of payments of the sterling area with the dollar area would deteriorate more in a slump if sterling were upvalued than if present exchange parities are maintained.

Suppose sterling had been upvalued in 1950. The terms of trade of the United Kingdom might have been more favourable. But they were deteriorating, and it is impossible to reverse the movement in the terms of trade by upvaluation. It will continue, though from a higher starting point. Since a deterioration of the terms of trade means that the country's goods are becoming more difficult to sell, a rise in the price of these goods (through upvaluation) is likely to make them less saleable. Hence the United Kingdom's balance of payments on current account would probably have been less favourable in 1950, had the pound been of a higher value. The terms of trade of the R.S.A. were improving in 1950. Perhaps it would have been possible to sell R.S.A. exports at higher prices in 1950, without corresponding loss of quantities. But even in the most favourable case it is unlikely that the sterling area as a whole would have fared better in 1950 if the value

of the pound had been different from what it actually was.

Now let us consider the effect upvaluation would have on the capital account. Suppose sterling were upvalued in times of raw material slump, when the R.S.A. withdraws more from the Pool than it puts in. Upvaluation would benefit all holders of sterling debts. It would increase their claims on the Pool. With sterling balances at a level substantially above monetary requirements, upvaluation would greatly increase the drain on the Pool. With the Pool at its present size it might well become completely exhausted. An attempt to raise the value of the pound sterling in such circumstances might well lead to its complete collapse.

If upvaluation were attempted at a time when funds are flowing into the Pool, because of rising raw material prices, upvaluation would reduce the sterling balance holders claims on the Pool. For example, if the pound had been at a higher value in 1950, the sterling debts would have risen less. Upvaluation then would have benefited the United Kingdom at the expense of the R.S.A.

Hence, failing other capital movements to offset the flow of funds from the Pool in times of slump, it would appear that the Pool is not yet large enough to withstand fluctuations of sterling balance movements at a higher value of the pound. Upvaluation will have to wait until either the Pool is much larger than at present, to withstand fluctuations of prosperity in the R.S.A. and the consequent sterling balance movements without danger of insolvency; or until the sterling balances in excess of monetary requirements are reduced to negligible proportions. 'If conditions remain what they are' it is quite possible that the problem of the excess sterling balances will be solved in the 1950's. Once this problem is solved, there will be no more danger of excess withdrawals by the R.S.A. in times of raw material slump. Then will be the time for considering upvaluation.

## 9. THE STERLING AREA AND THE DOLLAR

Through the joint Gold and Dollar Pool the sterling area system has, in a way, become a dollar exchange standard system. In the 1930's the sterling area system could be based on the United Kingdom pound sterling, simply because the United Kingdom pound sterling was then a generally acceptable international medium of exchange. In those days R.S.A. countries deliberately undervalued their currencies relatively to the United Kingdom pound sterling and this helped them to speed up

the accumulation of monetary sterling reserves. Now, the United Kingdom's heavy current indebtedness prevents sterling from being an uncontrolled currency. This as well as the preponderance of United States economic power makes it impossible for the time being for sterling to fulfil the same international function as the dollar. Now it is the United Kingdom pound sterling that is kept at a low value to help to speed up the accumulation of gold and dollar reserves.

Since the dollar is the most important international currency of the day, all countries must have a reserve of dollars or of gold (for which dollars and other currencies can be bought). Since the United States economy is the most powerful economy in the world today, it is of advantage to other countries to have exchange stability with the dollar, just as in the past it was advantageous to have exchange stability with the pound sterling. It will be shown below that it is cheaper for the sterling area countries to accumulate a joint reserve than to do it each in isolation.

The United States economy now is the principal determinant of world prices. This is so, because the United States is the principal manufacturing economy. In present conditions, primary product prices are determined largely by what happens in the manufacturing sector of the world economy, and manufacturing prices are determined largely by what happens in the leading manufacturing economy. This is true of cyclical fluctuations as well as of long-term tendencies. This point will be dealt with in some detail, since it is so easily and often overlooked. The last thirty years provide examples to illustrate it.

In most of the inter-war period, world trade stagnated or declined, and cyclical fluctuations were particularly marked. It was a period when population of North-Western Europe and North America had ceased to expand at the rapid rate at which it expanded in the nineteenth century. Most of the world's manufacturing economy is concentrated in this area and most of world trade is between or with countries in this area. With the slackening of population growth, one of the chief causes of expansion of industry and trade had ceased to operate.[1] In the absence of a long-term increase in demand, cyclical depressions were no longer ameliorated or hidden by a secular upward trend in demand. In industrial countries output expanded slowly and

[1] cf. W. A. Lewis: *Economic Survey, 1919 to 1939*, Geo. Allen & Unwin, London, 1949, Chapter XII.

employment opportunities declined. Every cyclical depression led to an absolute decline in manufacturing output and employment. When income declines in manufacturing countries the price offered to primary producers falls. The primary producer is not always in a position to do anything about it. Most of his capital (including land) is fixed capital, and in the case of agriculture in most of the world worked by owner-occupiers, so that a reduction of his commitments by discharging labour is often ruled out. Thus, if the industrial price offer is reduced individual farmers will often respond to it by an increase in output to maintain the income necessary to meet their fixed expenses. This accentuates the fall in prices. Farm income is reduced per unit produced. In times when industrial economies as a whole are experiencing a secular upward trend so that any cyclical industrial recession is short-lived, the farmer can often maintain his aggregate income by means of an expansion of output. But if the industrial sector of the world economy is stagnant, or even declines, the depression lasts too long and the cumulative price fall becomes too intense to maintain aggregate farm income despite expansion of output. Any such expansion in output is a further cause of the cumulative fall in prices. Eventually farm output will have to be reduced, but only after a time lag, because of the fixed capital and the difficulty in anticipating future demand. The fall in prices impoverishes the farmer and reduces his demand for manufactures. This in turn impoverishes the manufacturing sector of the world economy and further reduces the price it offers for primary products. The decline in the price of food often brings no relief to the individual farmer in the form of an expansion of demand, since the demand for many foodstuffs is highly inelastic. An individual food producer can maintain his aggregate money income for a time by producing more at a lower price per unit, but the farming community as a whole loses because of the consequent acceleration of the price fall. If the price fall is too great this way of escape is no longer open even to the individual farmer. The position of the raw material producer is no better. Here demand clearly follows the anticipated rate of profit in industry. In good times when prices are rising manufacturers lay in stocks of raw materials. When their stocks seem adequate for some time to come they cease to order further raw materials or ar any rate reduce their orders. This immediately affects the raw material producer's income who cannot always quickly curtail output for the reasons stated, particularly if he is engaged in the production of 'long

crops' (e.g. rubber) which take several years to mature and in which he may have invested considerably in good years. The effect on raw material producers' incomes affects their purchases of manufactures. Hence the so-called lead of our export trades into depression.[1] For example, the 1929 crisis was preceded by reduced industrial stock-piling and a fall in raw material prices as early as 1927 — particularly heavy because it was not only the normal cyclical stock-piling that had come to an end, but also the replenishment of raw material stocks in countries that had suffered from the consequences of the first world war. By 1928 some of our export industries, such as textiles, began to feel the pinch, although it was not until 1929 that the multiplier effects had worked themselves through the industrial economy and the depression set in. The sequence of events was the same in 1948-9. Post-war stock-piling was tapering off in 1948. Throughout the first half of 1949 primary product prices were falling. By September the crisis had gone far enough to undermine the value of sterling. The 1949 recession was only short-lived. The post-war expansion had experienced only a small relapse. American raw material purchases were resumed, and in particular United States Government stock-piling. In short, the lead into and out of cyclical depressions and the lead to long-term price movements is given by what happens to the anticipated rate of profits in manufacturing. This will remain true as long as the ratio of inescapable fixed costs is greater in primary production than in manufacturing, and as long as the demand for raw materials is a function of anticipated needs of industry (and it is difficult to visualize anything else).

Hence the manufacturing sector of the world economy is considered to lead the world economy as a whole. Within the manufacturing sector of the world economy the United States economy is predominant in international transactions. Her leadership appears to be the result of a combination of size and solvency in international transactions, and, at the same time, relative independence of international transactions. In 1950 the value of United States imports of merchandise was £3,317 millions.[2] The United Kingdom, the second largest single importing country, imported £2,374 millions of

[1] cf. Beveridge: *Full Employment in a Free Society*, Geo. Allen & Unwin, London, 1944, pp. 294 to 306.

[2] U.S. figures in this paragraph from *Survey of Current Business;* U.K. figures from Cmd. 8201, Cmd. 8203 and *Monthly Digest of Statistics.*

merchandise. The United States lead is marked, and slightly more so if the trade between the two countries is excluded. In this case the import figures can be taken as rough indices of the relative impact British and United States purchases make on the rest of the world. The figures are United States £3,198 millions, United Kingdom £2,163 millions. This means that for the export trades of the rest of the world as a whole, what happens in the United States economy matters even more than what happens in the United Kingdom. The quantitative lead of the United States, though marked, would not appear to be sufficient to give the United States more or less undisputed price leadership if other factors were not at work as well. The most outstanding factor would appear to be the solvency of the United States in international transactions. In 1950 her balance of payments surplus was £789 millions, compared with the United Kingdom's £244 millions. The United States' surplus was an unaided one, the United Kingdom's an aided one.[1] The United States gold reserves increased by £623 millions. This is not so very much in excess of the increase in the United Kingdom's gold reserves of £575 millions. However, this increase of £575 millions was the result of the transactions of the sterling area as a whole and was helped by North American aid.[2] The United States gold reserves on the other hand could have increased more in the absence of United States net lending. The United States has no payment difficulties. Her currency is a generally acceptable means of international payments. Exports to the United States are preferred to exports to the United Kingdom, because the United Kingdom currency is controlled and so is not such a generally acceptable means of international payment. The United States could even run a balance of payments deficit for a short time without impairing the value of the dollar since all other countries want to build up dollar reserves. Thirdly, the United States appears to be less dependent on international trade than the United Kingdom. The value of exports of goods and services amounted to about 6 per cent of the national income of the United States in 1950, but 28 per cent in the case of the United Kingdom. To sum up, the United States is the world's largest importer, one of the world's most solvent importers, and relatively independent of international transactions for her prosperity. Hence, what happens to United States' demand for imports affects world

[1] See Section 7.
[2] See Section 8.

trade more than changes in other countries' demand for imports; exporting countries prefer to sell to the United States rather than elsewhere; and changes in international trade affect United States' prosperity less than they affect the prosperity of countries such as the United Kingdom. No other country comes as near to the United States in quantitative importance as the United Kingdom, and the United States is even further ahead of the United Kingdom in terms of solvency and ability to do without the rest of the world. These are the reasons for United States' international economic leadership.

United States' international economic leadership affects other manufacturing economies not only *via* the prices the United States is willing to pay in her direct transactions with other manufacturing countries. Perhaps more important is the effect of United States' prices paid for raw materials on the raw material prices other manufacturing countries have to pay. This was of great importance after the devaluation of sterling. Where the dollar price was maintained, the sterling price of the commodities concerned rose. Hence there was a rise in United Kingdom import prices even in respect of imports from the R.S.A., whenever the commodity concerned had alternative markets in the United Kingdom and in the United States. The Korean war and the subsequent rearmament boom led to further price rises of primary products in the United States and this percolated throughout the world because other countries could not obtain primary products for which the United States competed without paying corresponding prices. When in 1951 the United States ceased to stock-pile some sterling area raw materials, the R.S.A. suffered declining incomes and the whole sterling area got into payments difficulties. We are now no longer surprised to read in the business columns of the newspapers that the London quotation of a primary product is largely determined by anticipations of the New York price.[1] When the United Kingdom devalued in 1931 things were different. The United Kingdom suffered no deterioration of the terms of trade then. The United Kingdom then was regarded as the leader of the world economy: other countries adjusted their prices to United Kingdom prices. Now the world adjusts its prices to United States prices.

[1] e.g.: 'Following a further setback in the Eastern price and *expectations of a 3 c. per lb. drop in the United States domestic quotation*, tin opened £12 to £15 lower on the London Metal Exchange yesterday.' Quoted from *The Times*, 9th June 1951, p. 9, Col. 2 (italics mine.)

The nineteenth-century gold standard and the sterling area system of the 1930's grew from countries' desire to have exchange stability with the United Kingdom, then the leader of the world economy.[1] Now that the United States economy leads, the question must be asked whether R.S.A. countries will, in their own economic interest, continue membership of the sterling area or whether they will prefer to join the dollar area. It will be useful to confine the analysis to its economic aspects and to ignore political considerations.

If the sterling area countries tried to obtain their gold and dollar reserves individually, each would have to curtail imports annually for some time to come in order to build up a stock-pile of dollars. If they did it individually instead of pooling their reserves it is likely that the aggregate reserves of all the countries concerned would have to be considerably larger than the Pool to give the same backing to the currencies concerned. The Pool saves dollars to the extent that any special demand for dollars on the part of one individual member can be met without undue strain on the Pool, as long as not all members have their maximum requirements at one and the same time. Should there be such pressure on the Pool from all at the same time, individual members are not likely to be worse off than they would be in isolation. In the absence of the Pool each member would have to do his own monetary stock-piling every year for some time to come. Thanks to the Pool not every member need be a net contributor each year. It was possible for the R.S.A. countries to take more out of the Pool than they put in in 1947 and 1948 since most of the deficit was covered by the United Kingdom (helped by North-American aid to the United Kingdom). In return the R.S.A. was the chief contributor to the Pool in 1946 and 1951, when the United Kingdom was in deficit with the Pool. It would appear, therefore, that the contributions to the Pool can be spread in time so as to be greatest in years when it is relatively easier.

It may be objected that if, say, Australia had not been a member of the sterling area in 1950, she could have kept her dollar earnings and have spent them herself in full. Instead she contributed the bulk of her dollar earnings to the Pool and got sterling in exchange. Less of what she wanted could be bought for sterling than could have been bought for dollars. The result was too much money relatively to goods in Australia and the Australian inflation was intensified. This argument

[1] See Section 3.

forgets that if Australia were to leave the sterling area she would have little or no backing for the international value of her currency. She would be compelled to stock-pile the dollars in her own coffers, instead of in London, before the Australian pound could face the world as an independent or direct dollar-exchange currency. It is quite likely that the quantity of dollars available for the purchase of current Australian imports would be less than under present arrangements, at any rate for some years to come. The experience of 1951-2 shows how hazardous it would be to anticipate a long period of years with Australian export prices rising more rapidly than the general level of world prices. If this cannot be assumed, Australia cannot change her monetary standard without great cost. The same applies to all other R.S.A. currencies.

In any case a change in the monetary standard would mean a waste of the sterling reserves the R.S.A. countries hold. By staying in the sterling area the countries concerned have currencies that are acceptable as international means of payment throughout the sterling area and also in Europe. Independent currencies would hardly be as widely acceptable in present-day conditions. As independent currencies, most R.S.A. currencies would have a lower value than at present. To have direct dollar exchange currencies, the countries concerned would have to start almost afresh in building up the monetary stock-piles needed as backing for their currencies.

The countries of the sterling area are united in the Pool for the external backing of their currencies. Now that the United States leads the world economy it is desirable to have exchange stability with the dollar. This is done more cheaply through joint currency policy than in isolation.

The sterling area countries, like all non-dollar countries, want dollars. To that extent they are competitive. If they competed for dollars individually they would bid against each other for dollars. It would then be quite impossible to have a stable value of these currencies in terms of each other and in terms of dollars. Through the Pool they economize dollars and avoid competitive depreciations of currencies.

In the 1930's the chief value of the sterling area system was that as a monetary union of complementary economies it led to stability in the value of sterling. This is of great importance even now. But in the building up of the joint Gold and Dollar Pool, the sterling area

countries act as a union of competitors for dollars who, acting in concert, keep up the value of their joint currency in terms of dollars. This way they cheapen the building up of the gold or dollar exchange standard. This sterling has become in all but name. It is not a dollar exchange standard proper, since the Exchange Equalization Account keeps its reserves in the form of gold rather than of dollars (or other foreign exchange). At the time of writing this makes no difference since gold and dollars are interchangeable. It is just a kind of insurance against fluctuations in the value of the dollar if the value of the dollar is liable to fluctuate more than the value of gold. However this may be, it does make sterling a 'conditional dollar exchange standard' and an 'unconditional gold exchange standard', in the sense that the value of sterling depends on the value of the sterling area's gold stock rather than its dollar stock.

CHAPTER III

# WESTERN EUROPE

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THE Western European countries' economies are largely competitive. Thus Western European economic co-operation or economic union must have different aims from the sterling area, which is a union of the United Kingdom with economies that are complementary to the United Kingdom economy. The principles of Western European co-operation will be the subject of this Chapter. They are the same, whether we consider monetary union or customs union. In what follows, emphasis will be on customs union. This does not mean that tariffs are considered more important than currency. But the exposition is simplified if the principles of economic union of competitors are worked out in connection with potential customs union (Section A). They will then be applied to the problems of the European Payments Union (Section B).

## A. THE PROSPECT OF CUSTOMS UNION

### I. THE POLITICS OF CUSTOMS UNION

Proposals for customs union in Western Europe are greeted with enthusiasm by some, with apprehension by others. Politically the argument revolves round the question whether customs union is an inevitable precursor of political union. There seems to be a widespread belief that this is so, and the example usually quoted to confirm such argument is the German Zollverein. If this argument is correct then customs union is premature while public opinion in potential member countries is not ready for a merger of sovereignty. Others point out that it is precisely because political union is not desired that relatively weak economic units join a customs union whilst preserving their

political independence. They cite too as an example the German Zollverein into which the smaller states joined to avoid political unification with Prussia. This they actually managed to stave off for a generation after the conclusion of the Zollverein. The Zollverein did not even prevent the majority of its members from siding with Prussia's enemy in the war of 1866.[1] Reference can also be made to the success with which small states like Luxemburg and Liechtenstein have preserved their political independence whilst enjoying the benefits of tariff union with a larger neighbour. The truth of the matter probably is that customs union between independent states can either be a forerunner of, or an alternative to, political union, according to the will of the participants.[2] A United Nations study of customs union lists customs unions in force since 1815.[3] It emerges clearly that customs union as such does not necessarily lead to any one political result. The customs union between Norway and Sweden (1815-97), and between Austria and Hungary (1867-1918) strained the political unions between these countries, though it probably was the periodical revisions of the terms of these unions rather than the customs unions as such that added to the causes of disruption. The South African customs union and the German Zollverein preceded political unification of most, but not all, of the member countries.[4] The Canadian and Australian customs unions coincided with political union. The customs union between Poland and Danzig was the result of war. The customs union between Belgium and Luxemburg was freely

countries. Last, not least, it must be pointed out that the Anglo-Scottish and the Anglo-Irish customs unions preceded very different developments in Anglo-Scottish and Anglo-Irish political relations. The history of customs union shows clearly that customs union as such is not associated with any one political cause or effect. Past experience is chiefly of interest, in a study of the administration of such unions. They show, for example, that periodical reviews of the terms of customs union agreements have usually been a source of friction. Yet such friction was politically important only where it merely added to other disruptive forces already at work and was not by itself a major factor in the break-up of such closer unions as the Swedo-Norwegian kingdom or the Austro-Hungarian empire.

Acceptance of the view that the political effects of a customs union are what the participants want them to be for reasons largely, if not altogether, extraneous to the customs union issue, does not commit us to the view that the same applies to the economic aspect. To gauge the possible economic effects of Western European customs union one can get even less assistance from history than in any discussions of the many possible political effects. In each past case one could point to special factors that were at work to shape the course of events. It will be necessary to make use of economic reasoning to elaborate the problems involved, and then apply the results to the special political and economic framework of our time. The results will largely depend on the exact meaning attached to the term 'customs union'. On this depends the further question which foreign economic policy practices are compatible with customs union.

## 2. DEFINITION AND ECONOMICS OF CUSTOMS UNION

Customs union implies joint action in tariff matters. In the loosest possible sense of the term this merely implies a *negotiating union*. The members retain their individual tariffs and do not even admit each others' goods free of duty or other controls. The union is confined to tariff negotiations with outsiders. One variant of such a negotiating union is the system of joint representation at trade negotiations. For example, since Ottawa, the British colonies have, whenever possible, been represented jointly at intra-Imperial and international trade negotiations. Concessions to be granted by, or to be obtained for, individual colonies were negotiated by the United Kingdom delegation acting for the colonial empire as a whole.

Another variant of the negotiating union is the system of simultaneous tariff negotiations as practised at Geneva, Annecy and Torquay. In this case there is not even unified representation of member countries (nor would complete unification of representation be possible since it would leave no one to negotiate with). It is merely an *ad hoc* union for simultaneous tariff action. Such simultaneous action is outside a strict definition of joint action. However, as will be shown below, in certain circumstances such an *ad hoc* union can achieve some of the results one associates with a negotiating union.

The second form of customs union is what sometimes is called a *free trade area.* Member countries retain their individual tariffs, but admit each other's goods free of duty, e.g. under the terms of the South African customs union agreements of 1930 and 1935. Such a free trade area is not necessarily accompanied by a negotiating union: the South African treaties mentioned did not join the Rhodesias into a negotiating union with the Union of South Africa. Joint tariff action is very limited in this case: it is confined to an agreement that only outsiders' goods are subject to import duty.

Thirdly, there is what might be called a *tariff confederation.* The participating countries become united for tariff purposes. No import duties are levied on members' trade, as in the free trade area; there is unification of trade representation as in the negotiating union; and in addition there is one single tariff for the union as a whole. It is a one-purpose pooling of sovereignty. In all matters other than the tariff the participating countries continue to have the right to pursue independent policies. It does not necessarily exclude all quantitative controls: even within the United Kingdom sugar is still 'zoned'. The tariff confederation is what usually is understood by customs union.

Fourthly, union for tariff purposes coupled with union for one or more other purposes can be called *economic federation.* Where the union is so close that all important economic issues are dealt with jointly or by a joint authority such an economic federation practically is a full *economic union.* Benelux, a tariff confederation since 1948, is on the way to becoming a full economic union. The Benelux countries have even proceeded to assimilate internal taxation to an extent not yet attempted between the forty-eight states of the United States.[1] Similarly, in the proposed Franco-Italian customs union, tariff confederation is only

[1] cf. U.S. Congressional Papers, House Select Committee on Foreign Aid, Sub-Committee on France and the Low Countries, Preliminary Report 24, p. 9.

regarded as the first step towards fuller economic union. There always will be differences in the degree of unification. Even a unitary state such as the United Kingdom has so far not been able to do away with substantial variations in local rates. In federal states the departure from complete economic unification is bound to be greater, and one will expect even greater variations in economic federations consisting of politically independent units. Fifty years ago a federation for tariff and monetary purposes would have been regarded as a fairly complete economic union. Today, owing to the growth of other protective devices, all possible forms of external trade policy would have to be included to make the union a full one for foreign trade purposes only. Today, a full economic union would also have to involve the merger of all powers that might be needed to maintain an adequate level of employment. Hence fiscal policy and certain other planning powers would have to be co-ordinated, before modern economic writers would regard the economic federation as sufficiently tight to deserve the name economic union. But even in the fullest conceivable economic union there are bound to persist at least some local divergences. Union does not imply uniformity in everything, but co-ordination (which sometimes requires uniformity) of essentials, of which the tariff is one.

It is most important to distinguish between these several meanings that may be, and are, attached to the term 'customs union', if confusion is to be avoided. The negotiating union directly affects members' trade relations with outsiders, but has only indirect effects, if any, on trade between the members. The free trade area, on the other hand, directly affects trade between the members, but has only indirect effects, if any, on trade with outsiders. Tariff confederation and economic federation affect both internal and external trade directly and may also have indirect effects on both. In what follows the effects of customs union on internal and external trade will be discussed with special reference to the economics of tariff confederation. Reference will also be made to fuller economic union, which will bring out the points relevant to negotiating union and free trade area as well.

Some hold that customs union is most desirable if member countries' economies are complementary. If Alpha is an industrial country and Beta a primary producing one, the disappearance of tariff barriers would facilitate a larger flow of trade between the two countries. However, in this case any duties Alpha levies on Beta's primary

products or Beta on Alpha's manufactures are in the nature of revenue duties, so that the disappearance of the tariff would effect little that could not be achieved without it. The two countries virtually are in a state of free trade anyway. The only case for such action is the desire to discriminate against third countries. There will then be an increase in world efficiency and world trade if the participants are lower-cost producers than outsiders, a decrease in world efficiency and trade if the participants are higher-cost producers than outsiders.[1] But the internal relations between such potential member countries present no case for a tariff confederation.

It might be argued that if there is no case for such confederation because all the advantages it could confer are enjoyed already, there might still be a case for economic federation, if only because the first obstacle (tariffs) presented no problem. Such reasoning rather presupposes the desirability of economic union. But the desirability or otherwise of any proposal depends on its possible effects. If in this case the proposal means that there must be such unification of the two countries' system of taxation that the revenue duties are replaced by excise duties on the consumption of the commodities concerned in both countries, the result in Alpha is that Alpha goods become dearer and Alpha has more left for export or produces less. In the latter case she will cut down her imports of raw materials. If in the process of readjustment of indirect taxes Beta's taxation of raw materials is reduced, Beta may buy more raw materials for home consumption. But if Beta does not reduce taxation, or not enough to absorb any possible reduction of consumption in Alpha, or cannot do so even in the absence of taxation, the increased exportable surplus has to be sold in the third markets. Should the quantity involved be sufficient to make an appreciable difference to the amount offered in third markets the world price falls and the union members may find themselves worse off than they were in isolation. An advantage from union can accrue to Alpha and Beta only in the limited cases when home consumption of exportable goods is negligible, and/or when both countries want to push their exports to a third country, Gamma; and Gamma buys both Alpha and Beta goods; and any fall in export price is at least compensated by an increased demand on the part of Gamma. Since tariff confederation is of no practical value

[1] cf. J. Viner, op. cit., p. 44.

and fiscal federation of limited value and perhaps even harmful, the question remains whether no form of economic union could be of benefit. Suppose Alpha and Beta are complementary economies but cannot fully satisfy each other's demand for imports which can only be obtained from Gamma. Suppose further that Alpha and Beta suffer from such a balance of payments problem with Gamma that they feel compelled to institute exchange control. If they cannot discriminate against Gamma they will have to cut down on each other's trade. The problem can only be solved if Alpha and Beta enter into a currency union which does not openly discriminate against Gamma. In this case Alpha-Beta trade can be maintained, or, owing to continued restriction on trade with Gamma, even expanded until in the most favourable case the increase in their mutual trade has so reduced demand for Gamma goods that the balance of payments problem is solved. It thus appears that a monetary union produces the same effect on trade with Gamma as a fiscal union would, but does so without the necessity to alter the internal fiscal structure. But it is of equally limited value as far as trade expansion is concerned. Whatever example one chooses, the effect of joint action by complementary economies can lead to greater stability of trade, but cannot by itself lead to trade expansion unless they have a common problem, e.g. the shortage of Gamma's currency. In fact they are competitive in this particular respect.[1]

The instances where two or more economic entities have common problems will be more numerous between competitive economic units. For example, in the labour market it does happen that the interest of employers and employees are such that they present a common front *vis-à-vis* third parties. More frequently, however, in capitalist society, the community of interests drives employees into employees' trade unions and employers into employers' associations. Failing such organizations, employee would so compete with employee for work and wages that wages would be lower than they are where there are trade union regulations. Again, employer would so compete with employer for factors and profits that factor costs would be higher and profits lower than they are where trade associations lay down rules that are generally obeyed. Similarly in international trade: the exchange of goods between, say, agricultural and industrial countries is essential

[1] For a more detailed discussion of economic union between complementary economies see Chapter II.

and some code of behaviour has to be drawn up, but there is no special need for a 'trade union' organization between any such pair of countries — unless they are faced by a joint (or competitive) problem *vis-à-vis* third parties. In some cases international commodity schemes will be the most convenient form of organization. Such agreements have been and are being negotiated for some primary products. But they are suitable only for commodities that can be traded in bulk and are easily graded. This excludes practically all manufactured goods and many agricultural products as well.

Industrialized countries, not enjoying a monopoly in their particular kinds of manufactures, may be tempted to consider customs union schemes. If they contemplate a tariff confederation (or only a negotiating union) they reserve the right to restrict one another's trade by quantitative import and export controls and exchange control. Even straightforward discrimination, e.g. by excise duty, will still be possible if the imported goods are clearly distinguishable from domestic goods and close, but not perfect, substitutes. Unless it is made a condition from the outset that all more effective forms of protection have to be removed from intra-union trade, a mere tariff confederation can only have limited effects on intra-union trade. Its effects will not differ substantially from the effects of a negotiating union. If in its relations with the outside world the confederation is confined to tariff matters while quantitative controls are administered nationally, the confederation is effective only to the extent to which the tariff is more restrictive than the national quotas. Only to that extent has the confederation something to bargain with in negotiations with third parties. It will be the more effective if quantitative controls of external trade are administered by the confederation, or if quantitative controls are regarded as temporary emergency measures only. In the latter case, third countries will still find it worth while to negotiate for tariff concessions, with an eye to the future. If the confederation controls all quantitative trade regulations with outsiders, or if there are no such quantitative trade regulations in force in any member country, the confederation is in a stronger bargaining position than its individual members in isolation, provided that the members all want the same concessions from third countries. For, as long as any concession a country grants has to be generalized owing to the operation of the unconditional most-favoured-nation clause, no country will grant the full concession to one of several interested

countries in order not to waste its bargaining strength *vis-à-vis* those other countries. What will not be granted to a country that supplies only a fraction of the imports of the commodity concerned, will be granted more easily to the largest single supplier. This is a widespread practice in trade negotiations and is fairly strictly adhered to by, for example, United States negotiators. It follows that the more competitive the countries that are embraced by the confederation, the speedier and probably also the larger in the long run will be the concessions the exporters within the confederation will obtain compared with isolated action. The advantages of tariff confederation over negotiating union to secure this result lie mainly in greater administrative simplicity, particularly in negotiations with outsiders.

It is quite conceivable that two or more countries present a united front *vis-à-vis* outsiders and yet preserve some internal quantitative regulations. This is projected for the wine trade in the proposed French-Italian customs union.[1] But it is unlikely that a tariff confederation would not be subject to strain if internal trade barriers were the rule rather than the exception in the long run. If internal trade barriers are abolished, changes in the internal price structure are unavoidable. It is often feared that the result would be large scale dislocation, widespread bankruptcies and unemployment. This argument must have been bred in a period like the 1930's when surplus capacity was the order of the day, when work had to be shared to make it go round, when shops were full and the pockets empty. The shops are filling again and there are signs of an emptying of pockets (successful disinflation), but the disproportion is still a long way from what it used to be in the '30's for the majority of the peoples of Europe.[2] Unemployment is still very much the product of a shortage of civilian capital equipment relatively to labour in countries that have lost the war (Germany and Italy) or to a relatively 'favourable' balance of payments position that makes the currency too hard for foreign buyers (Belgium). But there is not, at the time of writing, any substantial general unemployment problem owing to excess capacity. As long as this lasts an opening of markets will cause price adjustments and will affect the balance of payments, but is not likely to cause unemployment through increased competition, for the simple reason that there are

[1] cf. Report of French-Italian Mixed Commission, Rome, September 1948.

[2] cf. United Nations: *Economic Survey of Europe in* 1949, Geneva, 1950, Chapters II and III.

'shortages' and no great expansion in production is possible. The Marshall countries taken together still do not produce enough to maintain their living standards without external assistance.The heavy defence effort required by the present World situation accentuates this state of affairs. Moreover, governments pledged to full employment will have to pursue inflationary policies to be on the safe side if and when the 'natural' inflationary tendencies subside. Therefore it does not seem rash to anticipate some inflationary tendencies for some time to come.

Now, the price of a commodity in any market is determined by the cost of producing the last unit of that commodity coming on to that market, having regard to demand, while the lower-cost producers earn the difference between their costs and the last unit produced as a premium on efficiency (profit). The only countries that need fear a widening of the market through customs union are those with the lowest all-round efficiency. The others will find that some of their industries will expand faster (because of their greater profitability) in the state of union than in isolation, while other industries would find their growth retarded. In the worst possible case no industry will expand, but to get this result the country concerned must be the least efficient all round. In this worst possible case the national income is not reduced below pre-union level, though expansion may be retarded. In every other case the greater profitability of the more efficient industries and the consequent increased specialization on the more profitable industries will lead to an increase in the national income. All this applies as long as inflationary tendencies last. Should a depression set in, the least efficient country will suffer more than in the absence of union, the more efficient ones correspondingly less.

The disappearance of tariff walls between two countries intensifies the international division of labour. For this reason tariff confederation or economic federation is held to be particularly advantageous for small states,[1] though it is somewhat difficult to determine exactly what constitutes small size of states in the economic sense. Perhaps one could say that customs union proposals are not likely to appeal to the economic leader in world trade, but may appeal to other countries. Moreover, in case of full complementarity of members' economies

[1] cf. G. Haberler: *The Theory of International Trade*, Hodge, London, 1937, p. 391.

no further division of labour is possible between them — though there may be some trade diversions from third countries. In actual fact, countries are not often perfectly competitive or perfectly complementary. To the extent to which there is departure from perfect complementarity there is some scope for increased specialization in trades in which the two countries are competitive. The more competitive the economies the more scope there will be for geographical concentration of industries in the most economic location within the union. Perhaps there will be some economies of scale, though this might easily be exaggerated. Professor Viner points out that such economies are not likely to be substantial.[1] After all, there is not complete absence of trade in the absence of customs union. It is less the economies of scale than the economies of location that will come into play. As has been stated in the preceding paragraph, in inflationary periods this will lead mainly to differential rates of growth in the enlarged customs area; in the absence of inflation, especially in times of marked deflation, the industries with least efficient location will be driven out, the more efficient industries will now be protected to the extent to which they are lower down the list of potential bankrupts.

To the extent to which there is greater efficiency in the state of union than in isolation there will be a greater quantity of goods in relation to purchasing power in the union than there would be without it. The value of members' currencies will rise relatively to the value of outsiders' currencies. This tendency will also be brought about by enhanced negotiating strength — perhaps the more important factor in a potential Western European customs union.

Simultaneously, the higher efficiency premium earned by the more efficient countries can lead to the establishment of a union price level for union goods at a level higher than prevailed in the more efficient countries in isolation. This will be so if the starting point is one of full employment or over-full employment. In this case, export prices of the more efficient member countries will rise. Consequently their terms of trade will become more favourable. If the union embraces only a small fraction of the suppliers to the more important markets, outside competition will force prices down again if the union is not to lose markets. But if the union embraces a substantial proportion of suppliers of the principal commodities concerned, the higher price

[1] cf. J. Viner, op. cit., pp. 46–52.

level can be maintained. In this case the union gains because the terms of trade improve. It will be contended that there will be a reduction in outsiders' purchases. However, if the union embraces all the more important suppliers it will be correspondingly difficult for the buyers to find alternative sources of supply. The buyers will not necessarily cut purchases to such an extent that their total outlay on the commodities concerned is less than before: and if they cut purchases from the union, but at least maintain their total outlay on union goods, the union has correspondingly more goods available for home consumption without loss of foreign exchange. In general, the larger the proportion of supply controlled, the less price-responsive is the demand, the less therefore the quantity that has to be exported to obtain a given amount of foreign exchange.

If the starting point is one of unemployment, the most efficient country gains most within the union. It is in a better position to lower prices than its competitors. Consequently it will capture most of the union market. The fall in export prices need not be as great as would have been the case in isolation, as some competitive price-cutting can be avoided.

Thus, the most efficient country will be the chief beneficiary both in inflationary and in deflationary situations. In an inflationary situation the benefit will be largely at the expense of non-union countries. It comes from the improvement in the terms of trade with non-union countries. In a deflationary situation the most efficient country benefits largely at the expense of the less efficient members. In times of inflation the union as a whole is bound to gain. In times of deflation the loss of the weaker union members may counterbalance the gain to the stronger.

As long as the members of a tariff confederation maintain monetary autonomy a trade war between its members is still possible by means of competitive devaluations of individual members' currencies. This is a serious weakness of a mere tariff confederation compared with a fuller economic federation. On the other hand the temptation to devalue will occur less frequently for the simple reason that the common price level does away with the possibility of one competitor having a price advantage over another which one might try to rectify by means of devaluation. The necessity to revalue the currency in relation to outsiders' currencies will occur on certain occasions. But one of the contributory causes of such revaluation (differential price

levels in countries competing for the same third market) will have disappeared. In any case, the fact that one weapon of trade policy can still be used nationally, while another can only be used jointly with others is no argument either for or against joint action in one sphere. More important is the question whether devaluation on the part of one member country of a tariff federation is legally possible. Suppose Alpha and Delta are two competitive countries that have joined into a tariff confederation, and Alpha devalues her currency by 10 per cent while Delta maintains the old parities. To the extent to which import duties in the confederation are *ad valorem* duties there will be no legal obstacle: the amount of duty that has to be paid in Alpha's currency rises correspondingly and the amount to be paid in Delta's currency remains unchanged. No alteration of the tariff is necessary. But if the confederate tariff includes specific duties there will be difficulties. If Alpha does not change her specific import duties then the degree of protection in Delta will be 11 per cent greater than in Alpha. Thus the tariff confederation comes to an end unless either Alpha raises her import duties correspondingly or Delta lowers hers. If the confederation's import duties on the commodities concerned are bound to the existing levels in trade agreements with outside countries the first course is impossible without infringement of treaty rights. The survival of the confederation therefore depends on Delta's willingness to make the necessary alterations so as to make the confederation compatible with the new conditions created by Alpha. The only way out of this difficulty would be an internationally recognized agreement to fix tariff rates at gold parities or other parity independent of the actual valuation of member countries' currencies.

For unilateral devaluation on the part of confederate country Alpha to be in Alpha's interest, special conditions must prevail. For example, it is conceivable that in a trade depression both Alpha and Delta suffer from a deterioration in their balance of payments position. Delta wants to deflate to reduce the balance of payments deficit, while Alpha wants to inflate to maintain full employment. The different monetary policies will make it difficult to maintain the existing exchange parities and the tariff confederation will be endangered. Such a state of affairs is, however, less likely to prevail than is often supposed. For if the two countries are manufacturing countries they will depend on the import of raw materials. If the balance of payments is in actual deficit, Alpha cannot maintain full employment unless foreigners are willing to sell to

her on credit. This would be ideal and has been suggested as sound policy by many economists, including a United Nations expert study group.[1] Perhaps it will be possible to persuade the legislatures of potential creditor countries to facilitate the finance of foreign credit even in times of depression. It is likely, however, that in a world-wide depression such legislatures will think of the immediate needs of their own constituents first and will attach low priority to the needs of other countries. In this case Alpha cannot pursue a policy that is very different from what here is assumed to be Delta's choice. Full employment will have to be attained by other means. But if loans are available why should Delta not be as eligible as Alpha? Unless Delta goes through a bout of economic nationalism — in which case she would hardly be a member of a tariff confederation — she will prefer borrowing which enables her to afford a balance of payments deficit to the hard road of deflation. The occasion for Alpha to devalue with full knowledge that this will break the confederation need therefore arise only if one of the confederate countries decides on a course of economic nationalism that would break the confederation in any case.

Some will argue that if tariff confederation implies a common monetary policy with effects on the internal economy which might affect the level of employment, then tariff confederation really implies economic federation. Others will contend that the effects on monetary policy are no greater and may even be less than the effects of general convertibility of currencies at fixed rates of exchange, while artificially managed changes in exchange rates between currencies of competitive economies are likely to lead to competitive undervaluations with no clear result other than the deterioration of international relations.[2] Probably it is correct to say that tariff confederation implies a certain parallelism in external monetary policy. But as long as monetary policy is not subjected to joint management this parallelism hardly makes the confederation an economic federation, let alone a full economic union.

Fiscal autonomy is usually regarded as the true criterion of economic independence. It implies the right to levy taxes in whatever way one likes and the right to dispose of the proceeds in whatever way one

[1] United Nations: *National and International Measures for Full Employment*, Geneva, 1950.

[2] This statement does not adversely criticize devaluations that do away with overvaluation.

likes. A tariff confederation does not interfere with the distribution of expenditure, economic federation might do so, and economic union certainly would. A tariff confederation interferes with a country's independent right to change the proportion of revenue that is raised by means of a customs duty. True, this right is limited by trade agreements which allow countries to reduce tariff rates, but not to raise them. The difference between isolation and confederation is that in the former case bilateral negotiations fix the limitation of the country's right to raise tariffs, in the latter case the members of the confederation have to act jointly in respect of tariff changes in either direction. If the confederation is one of competitors so that they have enhanced their bargaining power in negotiations with outsiders, the contractual limitations on the confederate tariff may actually be less than would be the limitations on the individual tariffs. Even in this most favourable case a country's desire to join into, or keep out of, a tariff confederation will probably be influenced by the relative importance of customs duties in potential partners' budgets. The position varies widely. In general, the proportion of customs revenue to total revenue is lower the more industrialized and diversified the economy. This will make it easier to negotiate customs unions between more 'advanced' economies than between other partners. On the whole it is likely to be easier to negotiate a tariff confederation between countries of similar fiscal structure on the revenue side, or between countries that have already substantially limited their tariff autonomy in ordinary bilateral agreements. In the former instance a similar proportion of revenue falls outside the control of national exchequers. The more unequal the proportion of revenue involved, the more will it be felt that the country where customs revenue plays a smaller part gets the same advantages with less interference with autonomous action than the other partner or partners. Therefore it is possible to say that tariff confederation, and even more so, economic federation, will be more attractive to countries with similar fiscal structure on the revenue side than to any other pair of countries. Since the fiscal structure of a country depends largely on its economic structure, this point reinforces the argument in favour of union between similar economies and against union of dissimilar economies.

The outline of possible economic effects of customs union can now be stated as follows:

*External direct effects:* In negotiations with third parties there will be

gain if the union is one of competitive economies, as long as third parties grant concessions primarily to principal suppliers in order not to waste their bargaining strength. If the union is one of complementary economies there can be no such gain; there may actually be a loss to one of the union partners if the third country grants concessions which are of interest to Beta only, in return for favours in Alpha and Beta. Thus, there will be an advantage in a negotiating union between competitive economies and competitive economies only. The same applies to tariff confederation and economic federation (if it includes federation for tariff purposes) since these embody a negotiating union. A free trade area could not help.

*Internal direct effects:* There will be a tendency towards concentration of industries into the more efficient areas of the enlarged economic territory. This again presupposes a certain element of competition between participants before the union becomes effective. The effect of union is likely to make members' economies more complementary but this is not absolutely certain without further data. In times of inflation, boom conditions will be accentuated in the more efficient areas, but less benefit, if any, accrues to the least efficient areas. In times of deflation the tendency towards depression will be accentuated in the least efficient area and ameliorated in the more efficient ones. These effects can be brought about by a free trade area or any closer union implying a free trade area. A mere negotiating union could not do so.

*External indirect effects:* To the extent to which internal direct effects increase efficiency in the union, the purchasing power of money in the union rises relatively to the purchasing power of money elsewhere. In so far as this affects internationally tradeable goods, the terms of trade improve correspondingly.

*Internal indirect effects:* To the extent to which external direct effects improve the terms of trade, standards of living within the union will rise. There also will be a tendency to rely more on imports from outsiders for goods in which the union has not increased its comparative efficiency *vis-à-vis* third parties. The specialization that is important here is specialization within world trade in contrast to the specialization within union trade resulting from internal direct effects.

A negotiating union leads to the gains and losses of external direct effects and internal indirect effects, a free trade area to internal direct effects and external indirect effects. A tariff confederation or closer economic confederation leads to all four. To secure the beneficial

effects the member countries must be largely competitive to start with. The internal direct effects of a free trade area would reduce the degree of competition between the union and outsiders, which may or may not counteract any tendency towards increased internal complementarity due to internal direct effects. To ensure permanent beneficial external effects the specialization within the union must be in a direction which enhances the union's principal supplier position in outsiders' markets and thus enhances its negotiating strength.

### 3. THE CHOICE OF PARTNERS

Any one country that contemplates customs union will have to decide on possible partners, and whether the benefits a customs union can confer are worth the loss of any existing rights and obligations that are incompatible with customs union. The present section will deal with the choice of partners from the point of view of the United Kingdom, the following one with the compatibility of such a union with present-day British overseas economic policy practises.

The argument of the preceding section was that customs union can be of benefit only if the member countries' economies are competitive. For Britain this limits the choice of possible customs union partners to the industrialized countries of Western Europe and the United States. In many ways there is greater similarity and competitiveness between the British economy and the United States economy than between the British economy and the economies of continental Western Europe as a whole. But an Anglo-American customs union is not at present the subject of serious debate. The idea has its attractions but is not likely to gain much ground in the immediate future. The United States does not at present feel the need of enhanced negotiating strength for the simple reason that she is in a stronger negotiating position, in economic matters anyhow, than is any other country at present. Any artificial improvement in her terms of trade might well make the outside world even more dependent on American loans than at present. If, then, the burden of financing such improvement in her position is thrown back upon the United States, she does not gain any immediate advantage. The United States would gain more from the internal effects of a customs union with Britain owing to the greater efficiency of her industry in many, though by no means all, lines of production. The abolition of trade barriers between the United Kingdom and the United States would still leave both countries protected

by transatlantic transport costs, but there would be some shift in the location of industries in course of time. Within any one economic area command over resources tends to move, however slowly, towards the most prosperous centre. This is difficult enough to prevent in a trade-clogged world where it gives rise to the so-called dollar problem. It would be more difficult if trade barriers were removed. Such movement of resources would be harmful to Britain's absolute wealth (in contrast to relative wealth if compared with that of the United States) only if inflationary tendencies subside. But a policy that would make a full employment policy in depression even more difficult than it is likely to be anyhow is not likely to commend itself to British politicians of the present day. Thus, in an Anglo-American customs union the United States, as the economically stronger partner, would gain most from the internal effects of a customs union; she does not need the benefits of the external effects. Britain, the weaker partner, would gain most from the external effects of such a customs union; she would gain relatively less than the United States from the internal effects in times of inflation, and might even lose in times of deflation.

The case of a potential customs union between Britain and continental Western European countries is not perfectly parallel to that between the United States and Britain. The United Kingdom would be the stronger partner in such a union with any single continental country. Consequently Britain would gain relatively most from the internal effects of a customs unions with a continental competitor and relatively less than any such partner from the external effects. If the customs union included all her continental rivals Britain would still be the strongest single member. Only if her potential continental partners joined into a customs union amongst themselves first, and Britain joined in only after consolidation of the continental union, would Britain's relative strength be reduced. In such case the potential gain to Britain would shift correspondingly from internal effects to external effects. The differences between any potential British-West continental customs union and a customs union between the United States and Britain are: First of all, that Britain cannot be indifferent to any strengthening of her negotiating power that would improve her terms of trade. Even if others stand to gain more from it this might still be the most important gain. Secondly, any such improvement in Britain's terms of trade would reduce the weight of present, and the

magnitude of future indebtedness. Thirdly, and perhaps most important of all, Britain shares with West continental Europe and other countries the problem of the dollar shortage. On strictly economic grounds there is, therefore, at present a stronger case for customs union between Britain and her continental competitors than for an Anglo-American customs union.

Not all forms of customs union can confer all these benefits, while some of these benefits can be obtained by confederation in respect of matters other than the tariff. The present state of affairs is that the United Kingdom joins *ad hoc* negotiating unions with other countries at international tariff conferences (Geneva, Annecy and Torquay), and is a member of the confederation of recipients of Marshall Aid which in turn has made her a member of the Marshall countries' quota confederation and their limited monetary confederation. At the international tariff conferences the United Kingdom negotiates simultaneously with other countries and this has the advantage that concessions can be obtained more speedily. It is of advantage to the United Kingdom to be able to negotiate with the United States at the same time as other countries suffering from the so-called dollar problem, and to negotiate with primary producing countries at the same time as the United States and other industrialized countries. The advantage of these simultaneous international tariff negotiations is however largely confined to speed, since negotiations continue to be bilateral. The full external advantages of negotiating union could only be realized if the countries represented at these conferences paired off on the basis of joint interest. There was some pairing off at Annecy, but it was on the wrong basis from the point of view of the problem under consideration. With one exception, the twenty-three countries that had negotiated the Geneva agreements did not negotiate amongst themselves at Annecy, but with a dozen newcomers with economies about as diverse as the economies of the twenty-three Geneva countries. In so far as there was grouping it was between old and new members instead of grouping on the basis of common economic interest. The results of Annecy accordingly were somewhat disappointing. The same procedure was repeated at Torquay. Negotiations were largely between old and new members. The results were as disappointing as those of Annecy. But in the long run the actual tariff results might be of secondary importance; of much greater value would be familiarity with the idea of the negotiating union, however imperfect it may be

in the early stages. Whether proper negotiating unions will develop out of the international tariff conferences is still doubtful. At any rate they provide a possible nucleus from which such negotiating unions could develop.

Another legal framework for international economic co-operation has been provided in the form of the Office of European Economic Co-operation of Marshall Aid Receivers. This is a tighter organization than international tariff conferences can be, not only because of its more permanent character, but also because the countries represented at O.E.E.C. are bound together by the common interest of reconstruction and of the so-called dollar shortage. Among its achievements the quota and monetary confederations are of special interest in this connection. In times when quantitative restrictions and exchange control are stronger barriers to trade than tariffs, their regional disappearance is of greater immediate significance than a tariff union could be. The members of O.E.E.C. decided to abolish quotas on their trade with each other. The aim was that all such quotas should disappear by 1952. By November 1951, over two-thirds of intra-Marshall countries' trade had been freed from quotas. The United Kingdom had abolished quotas for as much as 90 per cent of her imports from other Marshall countries. The exigencies of rearmament necessitated a reversal of this policy of liberalization on the part of the United Kingdom. In November 1951 the British Government felt compelled to reduce liberalized imports to about two-thirds of the United Kingdom's imports from other Marshall countries. Further cuts in January and March 1952 reduced this proportion to about 45 per cent.[1] This temporary reversal of United Kingdom trade policy *vis-à-vis* Europe will be discussed at greater length in Section B of this chapter. Here it must suffice to point out that, despite the cuts that were imposed on the civilian economy, nearly half the United Kingdom's imports from Marshall Europe remained free from all quantitative controls. Despite all difficulties, this remains the most important step in the direction of a European free trade area that is possible in present circumstances. It is made effective by the European Payments Union which alone makes this partial freeing of trade a reality. Without it, the reduction in quotas would be meaningless, since exchange control would take their place. The European Payments Union is not a complete monetary

[1] cf. *Midland Bank Review*, February 1952, pp. 5 and 6; and *Keesing's Contemporary Archives*, 1952, Col. 12095B.

union, but makes interchangeability of members' currencies easier than interchangeability of members' currencies with non-members' currencies. By the time intra-Marshall countries trade is sufficiently freed from quota and currency controls so that these controls will be the exception rather than the rule, tariffs will again be important. External quotas and exchange control are still administered nationally. If they are to survive internal (i.e. intra-Marshall countries) quotas and exchange control, as is probable, it will be worth considering whether a negotiating union in quota and currency matters is practicable. If so, it would enhance members' negotiating strength *vis-à-vis* outsiders. Failing that, the chief beneficiaries will be the economically strongest members who stand to gain most from the internal advantages of a quota confederation. The weakest members would benefit most from a negotiating union relating to external quotas.[1] The same applies to currency controls. So far it has not been found possible to extend European economic co-operation to the creation of a tariff confederation which together with quota and currency confederation, however limited, would make the Marshall countries a proper foreign trade federation. So far this has not been as important as it soon will be. Is it likely to materialize? What changes would be necessary in British economic overseas trade policy to make it possible? Is it worth the price?

## 4. UNITED KINGDOM OVERSEAS TRADE POLICY AND THE PRICE OF CUSTOMS UNION

Present day British overseas trade policy is of necessity protective. Britain's armoury of protection includes all the weapons of trade policy that are compatible with modern international commercial behaviour: exchange control, quotas, bulk purchases, tariff protection and Imperial preference. Few are enamoured of all these weapons. Fewer still seriously believe that they can be discarded for some time to come, unless alternatives can be found suitable for present-day economic circumstances.

Free trade is the ideal. It has been one of the aspirations of the noblest thinkers throughout the ages. But free trade theory has become free trade practise only when certain conditions obtained. Nineteenth-century free trade depended largely on United Kingdom credit to

[1] The same analysis applies to quota confederation as to tariff confederation for the problem under review. See Section 2.

primary producing areas. On the basis of such investment primary production in debtor countries was expanded beyond the United Kingdom's requirements. Nevertheless the United Kingdom fully benefited from her overseas investments by the device of admitting free of protective duty not only the increased quantity of primary products on offer, but also the products of third countries to which the excess production of primary products was sold[1]. There is no prospect at present of a return to a system of multilateral world trade based on United Kingdom credit and United Kingdom free trade. It requires an amount of domestic savings that is not likely to be forthcoming in Britain as far as one can see. There is a fair prospect of late twentieth-century multilateralism based on United States credit and United States free trade. But other countries are likely to remain somewhat more protectionist than the United States until their productive capacity is great enough to enable them to save sufficient for international credit creation on a corresponding scale. If a British lead towards free trade is excluded, an alternative to present-day British overseas trade policy must be sought for elsewhere. The only alternative compatible with the General Agreement on Tariffs and Trade would be a customs union. Customs union may be a step in the direction towards free trade because of its internal effects. It is a protective device *vis-à-vis* outsiders because of its external effects.

British quota control has already been relaxed in favour of the Marshall countries with the result that the Marshall countries receive preferential quota treatment in the United Kingdom compared with the treatment received by all other countries outside the sterling area. Exchange control continues to be applied to all non-sterling countries, but the European Payments Union allows for greater flexibility in its administration *vis-à-vis* the Marshall countries. In other words the most effective weapons of trade policy are already less severely applied to Europe than to other foreign countries and even to Canada which has a dollar currency. Should joint negotiations with outsiders about external quotas or joint administration of external quotas be possible, as well as joint administration of the Payments Union, the Marshall countries will be well on the way towards external trade confederation, even without a tariff confederation to start with.

Bulk purchase contracts are long-term agreements by which the

[1] cf. United Nations: *International Capital Movements during the Inter-War Period*, Lake Success, 1949, p. 47.

United Kingdom Government undertakes to buy fixed quantities of primary products at agreed prices over a fixed period of time. The United Kingdom has such bulk purchase agreements with a number of Commonwealth and foreign countries. Bulk purchase agreements do not seem to be incompatible with any form of customs union. Even in a full economic union, bulk trading by member countries' governments would not be very different in principle from municipal trading.

In short, outside the tariff sphere itself, British trade policy practices either tend in the direction of special arrangements with Western Europe or are irrelevant to the customs union issue. The tariff itself is a source of revenue as well as a method of protection, so that a tariff union involves problems that do not arise in a quota union. The temporary suspension of the Belgian and Netherlands tariffs after the war certainly made the Benelux negotiations somewhat easier: the problems of customs revenue and tariff protection were not as formidable as they normally are.

If the United Kingdom joined a customs union she would lose independent control over customs revenue. In recent years customs revenue has represented about 20 per cent of her total ordinary revenue. A closer analysis of United Kingdom customs revenue shows, however, that only a small fraction of customs revenue is derived from commodities of interest to Western Europe. Customs duties on unmanufactured tobacco alone bring in more revenue than all other customs duties taken together. Other substantial sources of revenue are mineral oil, alcoholic beverages, sugar, tea and other tropical produce.[1] Of these only alcoholic beverages and, potentially, sugar are of interest to Western Europe. One is likely to err on the high side if one expects a complete removal of customs duties on Western European goods to involve as much as 5 per cent of total ordinary revenue, even when allowance is made for possible diversions of trade. The loss of revenue would be less if some of the customs duties could be replaced by excise duties, or if the United Kingdom tariff were replaced by a higher union tariff; in the reverse case the loss would be greater. The most important issue from the revenue point of view would be the maintenance of the present rates of taxation on tobacco, mineral

[1] cf. Treasury: *Financial Statements;* Board of Trade: *Trade and Navigation Accounts;* Commissioners of H.M. Customs and Excise: *Customs and Excise Tariff in Force on 1st January* 1950, and *Annual Reports.*

oil and alcoholic beverages, where necessary by an increase in excise duties. In all this it is assumed that the United Kingdom would retain all customs receipts levied by the United Kingdom customs authorities, just as Belgium and the Netherlands keep the duties levied at their respective frontiers.

A mere negotiating union would not entail any sacrifice of revenue. It would still restrict independent action in respect of tariff rates. Freedom of action in respect of tariff rates is already restricted by trade agreements. For example, in the Geneva tariff agreements the United Kingdom bound herself not to increase duties on goods which in 1938 represented over 10 per cent of her imports.[1] In this respect a negotiating union would do more quickly what bilateral trade agreements do gradually. However, if the negotiating union increases members' negotiating strength, the concessions to outsiders would be less than in isolation. A negotiating union would also do away with freedom to lower duties without consultation with others. This theoretical possibility must not be ignored, but it is of limited importance these days when unilateral tariff reductions are quite exceptional.

At present the tariff is of relatively little protective importance. But gradually it will come into its own again in intra-European trade as quotas are dismantled and exchange control relaxed. The British tariff consists of *ad valorem* duties and specific duties. Usually specific duties are used where protection is intended to be particularly heavy. The proportionate incidence of *ad valorem* duties is not affected by changes in the value of money. Specific duties on the other hand increase in *ad valorem* incidence when the value of money is rising, and decrease in *ad valorem* incidence when the value of money is falling. The value of our money has been falling throughout the last decade, and devaluation has further reduced the relative protective effect of specific duties expressed in sterling on foreign goods produced in areas with currencies that have not been devalued correspondingly. The protective character of the British tariff is therefore completely skewed by these monetary causes. If it were intended to return to a tariff of the same ralative protective incidence as the pre-war one, it would be necessary to raise all the specific duties. If further inflation is expected, these specific duties would have to be expressed in terms of a neutral index, e.g. gold parities, so that they can be changed continuously to retain their protective effect. Alternatively, the specific

[1] cf. *Report on the Geneva Tariff Negotiations*. Cmd. 7258.

duties would have to be converted into *ad valorem* duties which are not subject to such changes as a result of monetary inflation. Such action has not been the subject of public debate, partly because the tariff is ineffective as a method of protection while stronger controls are applied; partly because the fall in the value of our money compared with foreign money has a protective effect of its own, however much it may skew the protective structure; and partly because the legal obstacles seem insurmountable. Many specific rates of duty are fixed by trade agreement and no increase is possible without international complications. The odd, but inescapable, result of all this is that a degree of protection equivalent to the pre-war one is possible only if either controls other than the tariff are maintained, or if by means of a customs union treaty an escape is found from present limitations on tariff sovereignty and some protection sacrificed for compensating heavier protection against outsiders. Nobody has as yet advocated a customs union for this reason only and it is unlikely that anybody will. But the point to be borne in mind is that tariff protection cannot be as strong again as pre-war without an increase in many tariff rates, largely on account of monetary factors and to some extent also as a consequence of various trade agreements. Hence, the sacrifice of protection involved in a customs union with internal free trade would now be less than is often supposed. It may yet be an unsurmountable obstacle. Some loss of protection and some loss of revenue are part of the price that would have to be paid for a free trade area, tariff confederation or economic federation. The price of a negotiating union is less: it is confined to the loss of direct control over tariff rates in so far as this has not been abandoned anyhow in trade agreements.

The thorniest problem of all, as far as the United Kingdom is concerned, is that of Imperial preference. The case against customs union is often presented in terms of the loss of Imperial preference. To appraise such arguments it is necessary to deal with the economic, legal and political aspects of the problem.

The economics of Imperial preference is the economics of price discrimination. Where preferred production falls short of preferential consumption the preferred producer receives a higher price than before, the increase being within the range of the margin of preference. In this case the preference is successful to the extent to which it raises the preferred producer's income. This inflationary effect is limited by the fact that the maximum possible benefit consists of the difference

between the world price and the world price plus the margin of preference. The displaced foreign producer is driven out of the protected market and in search for new outlets increases competition elsewhere so that the world price is depressed. How far this deflationary effect on world trade counteracts the inflationary effect on Commonwealth trade will vary from case to case. Since the deflationary effect on world trade cannot but have repercussions on world income and consequently on Commonwealth trade, it cannot be said with precision how great the benefit of Imperial preference is, except that almost invariably it is less than the margin of preference times quantity sold to the preferential market. Where preferred production exceeds preferential consumption and discrimination against the preferential market is precluded, the price the preferred producer receives is set by the world price and the only effect is trade diversion. The preferred producer can gain only if he is allowed to discriminate against the preferential market: in which case the burden of the preference is again shared between the preferential buyer and any displaced foreign competitors who find it difficult to find alternative markets. It follows that there is only a limited number of commodities which are suitable for preference without hurting the giver as much or more than they benefit the receiver. In the absence of discrimination against the giver, the list is confined to commodities in which the Commonwealth as a whole is not self-sufficient — or, more accurately, of which Commonwealth exports fall short of the imports of preferential Commonwealth markets.[1] This excludes practically all the major exports of the United Kingdom. Before the war the only dominions that gained much were New Zealand and India. New Zealand's gains were in butter, meat and cheese, but not in respect of wool of which the Commonwealth had an export surplus. India's gains were in tea, oil seeds and rice. India could also have gained from a United Kingdom preference on raw cotton; but this was not given since it was feared that this would raise raw material costs to the Lancashire textile industry, and Lancashire was already sorely tried on account of heavy competition by lower-priced foreign (especially Japanese) textiles. The Commonwealth had an export surplus of raw jute so that Indian jute producers could not have gained from preferential tariffs. Eire could have gained in respect of her exports of dairy produce to the United Kingdom, but

[1] cf. F. V. Meyer: *Britain's Colonies in World Trade*, issued under the auspices of the Royal Institute of International Affairs by Oxford University Press, 1948, Chapter 7.

did not do so on account of an Anglo-Irish trade war in the 1930's. Australia's principal exports are wool and wheat, and the Commonwealth had an export surplus of both. But Australia gained from the preferences on butter, meat and sugar. Canada gained something from the preferences on wood and timbers and had an interest in the United Kingdom shadow preference on copper. This consisted of an undertaking by United Kingdom copper consumers to buy in the Empire as far as possible, provided the tariff preference was not actually imposed and the Canadian price not raised, i.e. provided Canada did not insist on the beneficial income effect of a staightforward preference. Canada gained nothing from the wheat preference and consequently did not suffer when it was removed, with her consent, under the terms of the Anglo-American trade agreement of 1938. The principal exports of the Union of South Africa are gold and diamonds: no preference can be of benefit. Of the colonies only the West Indies, Mauritius and Fiji gained substantially (sugar and bananas) and some benefit also accrued to East Africa (tobacco and coffee). The other colonies, like most of the dominions, gained comparatively little, and lost substantially since monopolistically organized manufacturers in the United Kingdom and some of the dominions could discriminate against the givers of preference. The result, in those parts of the Commonwealth that could not do likewise and did not produce commodities in which the Commonwealth as a whole was short of 'self-sufficient', was an inflationary effect on import prices without corresponding effect on export prices. This meant a lowering of their standards of consumption below the free trade level. It is fairly certain that this even applied to the United Kingdom which shouldered most of the burden of the indirect subsidy to those parts of the Commonwealth that gained without equal net gain on the export side. It has been contended that any beneficial effects a preference can confer might as well be achieved by means of payment of direct subsidies, as is done in the Colonial Development and Welfare schemes or in a different form in the free grants some of the dominions have made to the United Kingdom in recent years. The argument is that these direct methods of subsidization have the advantage that the giver at any rate knows how much he pays without risk of being discriminated against in return, while the receiver is not just an industry but a country. This argument has the advantage of logical consistency, but this method may not always be practicable on political grounds. A limited amount

of preferential tariff arrangements between Commonwealth countries will probably have majority support for some time to come.

The instances where Imperial preference was successful are all cases of preferences on commodities which the preferential buyer does not produce at all, or in insufficient quantities for home requirements. The unsuccessful cases include some such apparent complementarities; but here the preferential buyer could not absorb the whole output, so that the element of competition for markets among preferred suppliers continued to be of importance. Where the preferential buyer was in direct competition with a preferred supplier, preference either was not granted or granted in such a way that even the preferential tariff was highly protective (e.g. certain dominion preferences on manufactures) and sometimes led to friction. A preference will be successful only where the element of complementarity between buyer's and seller's economy outweighs the element of competition between buyer and seller and also the element of competition amongst the sellers themselves. Since customs union is most beneficial between competitive economies and tariff preferences between certain complementary economies, there is no incompatibility on economic grounds between customs union among competitors and preferential tariff arrangements with complementary economies, provided the partners can be chosen on this basis. On the whole the United Kingdom economy is complementary to the economies of the overseas Commonwealth and competitive with continental Western Europe. But there are important exceptions: e.g. Denmark is much more competitive with New Zealand and Canada than with the United Kingdom. A customs union involving unqualified free trade between all Marshall countries might well interfere with the working of the successful United Kingdom preferences on butter, meat, cheese and perhaps also sugar. In case of Western European customs union it would be necessary to find ways of guaranteeing such benefits to the Commonwealth by preference or otherwise. But it should be borne in mind that most of the commodities concerned are likely to remain subject to governmental bulk purchase in the United Kingdom for some time to come. As it is, bulk purchase often leads to price discrimination against Commonwealth countries, so that Imperial preference is largely inoperative at present.[1]

[1] cf. 'Bulk Purchases', *Economica*, February 1948. More recent evidence has been provided e.g. by the dispute about the West Indian sugar contract in 1950. See also *The Times*, 27th March 1952, 'Agreement on Sugar'.

Legally, the United Kingdom has bound herself in various commercial treaties with the dominions not to reduce preferential margins without the other contracting party's consent, as long as these agreements remain in force. Such consent has so far always been forthcoming when it was required for the completion of a trade agreement. The most important pre-war trade agreement was the Anglo-American trade agreement of 1938, when margins of preference were narrowed, conventionalized or abolished on such a wide range of commodities that any further important extension of Imperial preference was ruled out. The intention in 1938 was to bargain preferences for reductions in the American tariff as a step towards freer world trade on a multilateral basis. The limitation of preference to 1947 levels (not very different from the 1938 ones) in the Geneva Tariff Convention appears but a logical successor to the 1938 agreement. New initiatives are allowed only for development purposes. In practice this means that new initiatives are limited to commodities in which the Commonwealth is not self-sufficient. 'Development' usually is understood to mean development of backward areas, so that no new initiatives are likely to be possible in favour of the United Kingdom or the dominions.

There are practical limitations as well. They are due to the increase in the degree of monopoly in primary produce markets. At first sight it would appear that this would widen the scope for preference: primary producers of commodities in which the Commonwealth has an export surplus would now be in a better position to discriminate against the United Kingdom. It is hardly likely, however, that the United Kingdom will be in a position to afford this for some time to come without strengthening her own bargaining power in return.

However this may be, the future of Imperial preference depends at least as much on political factors as on economic ones. There can be few economic measures that have aroused so much passion on either side, at any rate at present, quite out of proportion to the economic significance of the issue. The subsequent paragraphs are written on the assumption that this feeling is sufficiently strong to make customs union impossible unless it can be combined with the continuance of a certain amount of Imperial preference.

Benelux and the proposed French-Italian customs union make no provision for the inclusion of overseas territories. Each metropolitan

power reserves the special relationships with the respective overseas territories. It has been suggested that the United Kingdom's special relationships could be equally safeguarded by special provision by which the United Kingdom reserved the right to charge lower duties on Commonwealth goods than other customs union partners.[1] Such procedure would be simpler for Great Britain, an island, than for continental powers with their long land frontiers. Such procedure would also ensure the United Kingdom's position as *entrepôt* centre for Commonwealth goods. This argument assumes that the United Kingdom and the Commonwealth would prefer to have their special relationships thus safeguarded to a system by which the whole customs union granted preference to overseas countries especially linked politically to one of the member countries. Alternatively, the special connection between the United Kingdom and the Commonwealth could be secured by special bulk purchase arrangements in respect of certain Commonwealth goods. On the Commonwealth side, preference to the United Kingdom could be retained without extension to other customs union partners by means of continuance of the certificate of origin system. Here the difficulty is not technical, but to secure recognition of this special right by other countries. It would be part of the price other customs union partners would be required to pay for customs union with the United Kingdom.

The question of Imperial preference is the most intricate one of all the economic problems involved in the customs union issue, but it is not beyond solution. As far as economic policy is concerned special arrangements with Western Europe are already an established practice on the part of the United Kingdom. Its extension to the tariff sphere may soon be an acute problem. It is technically possible to do this with safeguards for Commonwealth interests. Where customs union partners' economies are competitive with the United Kingdom's, customs union would lead to certain economic advantages at the expense of some protection for United Kingdom industry. It has been suggested[2] that this should be done by means of preferential tariffs, somewhat higher than the British preferential tariff, but lower than most-favoured-nation rates. Such a proposal has the advantage that protected interests will be more ready to accept such a half-way house than a full customs union. Apart from such political advantage,

[1] cf. R. F. Harrod: 'European Union', *Lloyds Bank Review*, July 1948.
[2] cf. Sir Arthur Salter: 'Western Europe', *The Times*, 16th and 17th May 1950.

the preferential solution is in present circumstances a possible economic solution for trade with complementary economies in Europe, if special tariff favours are to be granted to Europe, bearing in mind the economic limitation to the value of any such preferential arrangement. It is more doubtful whether tariff preference to continental Marshall Europe would be any use if applied to competitive economies, except as a transitional measure *en route* to tariff confederation. It would deprive the union of the full internal advantages of customs union, without strengthening the external advantages beyond what they would be if there were a mere negotiating union without any internal tariff change. Merely to intensify competition without reaping the full advantages of higher productivity is likely to lead to more friction than a union of politically independent units is likely to endure. The practical difficulty is that a tariff union with the industrially more advanced Western European countries, without inclusion of the agricultural ones, might be politically impossible. It would be necessary to explore the possibility of differentiating on a commodity basis: full tariff union in respect of industrial goods and preferential arrangements in respect of certain agricultural ones. This would simplify the safeguarding of Commonwealth interests. It is attempted for continental iron and steel and coal by the Schuman Plan. Were it not for the political difficulties about the High Authority (which is not an essential feature of a customs union) and that the British Government felt it politically impossible to let Britain join in as a full member, Britain would be the principal economic beneficiary; the British iron and steel and coal industries are on balance more efficient than the continental ones.[1] The possibilities should be explored of associating the United Kingdom with the tariff union aspect of the Schuman Plan, even if membership of the High Authority is considered politically unacceptable.

If matters are not complicated by special political issues, such as the Schuman Plan High Authority, the difficulties in the way of customs union as such can be summarized as follows: If the union involves the creation of a free trade area in Marshall Europe there is the problem of the possible loss of some revenue and of independent control of a portion of revenue; the loss of some protection to home industry; and the difficulties in the way of safeguarding Common-

[1] See section 2.

wealth interests. These are the price of Western European free trade, which must be balanced against the advantages. The creation of a mere negotiating union bristles with fewer economic difficulties, but might be administratively more difficult. It is hard to see that there should be political obstacles in the way of tariff confederation that do not apply to the limited currency and quota confederations already in force, except one: the difficulty of creating machinery for joint negotiations with outsiders. Without such joint negotiation the external advantages of customs union cannot be obtained. These would benefit some other countries more than the United Kingdom, but even for the United Kingdom the external advantages might be the more important inducement to consider possible customs union schemes than the internal advantages. The external advantages can be had with a minimum of adjustment in the present structure of British external trade policy. The minimum price that would have to be paid is co-ordination of British and other West European tariff negotiations with outsiders. This is a political price. Can it be paid?

## B. THE EUROPEAN PAYMENTS UNION

The customs union issue will remain an academic one as long as trade between potential members is subject to quotas and exchange control which restrict trade more effectively than tariffs. Within Marshall Europe quotas are being gradually abandoned. Exchange control still is applied to transactions between Marshall countries, but capital transfers are considerably eased by the European Payments Union. Once all quotas have been abolished and currency movements are freed from all control within Western Europe, the customs union issue will become an important practical issue: but not until then. In the meantime, the removal of quantitative trade barriers and relaxation of currency movements bring about results that would be intensified if liberalization of trade within the area went as far as the removal of tariff barriers as well.

The gradual abolition of quotas would indeed be meaningless were it not accompanied by increased transferability of currencies. Otherwise there would be no means of payment with which to buy the 'liberalized imports'. The transferability of currencies within Marshall Europe is now regulated by the European Payments Union of 1950.

It is not intended to go into great detail about the origins and working of E.P.U.[1] Let it suffice to give a very rough definition and outline of rules during the first two years of its operation. Then some of the effects of E.P.U. on the British economy will be considered.

E.P.U. is a limited system of multilateral payments. 'Limited' because it does not yet permit free interconvertibility of E.P.U. currencies. Intra-E.P.U. transactions are still subject to exchange control. However, it permits the use of any surplus any E.P.U. country earns in its current transactions with another E.P.U. country for payment to any third E.P.U. country with which the first country is in deficit. For example, if the United Kingdom earns a surplus in her current transactions with, say, Norway, but has a deficit in her current transactions with, say, France, the United Kingdom can use her net earnings of Norwegian kroners to pay France. The United Kingdom does not pay these Norwegian kroners to France directly; the procedure is that the United Kingdom pays these kroners to the Union in return for E.P.U. units of account which are generally acceptable within the Union in discharge of debts. The United Kingdom then settles her debt with France in E.P.U. units of account. The Union accepts all member currencies within strictly defined limits. Were there no such limits there would indeed be free interconvertibility of member currencies. As long as some member countries are liable to run very high deficits with other E.P.U. countries, a ceiling has to be put on the amount of any one currency the Union will accept, lest the reserves of the Union should soon consist of nothing but debtor currencies which nobody wants. The ceiling is put by the so-called quotas.

When the Union was formed, a portion of Marshall Aid dollars was set aside to be the central currency pool and to give the Union adequate gold reserves to meet all anticipated demands. Each member was given a 'quota', in most cases about 15 per cent of the value of its trade with the other E.P.U. countries. The quota is the limit within which a member can resort to the Union to settle any credit or debit balances. One-fifth of the quota can be used to settle unbalances by credit: a surplus country extends credit to the Union, a deficit country receives credit from the Union. If there are further net surpluses within the quota, a surplus country extends credit to the Union to the amount

[1] An excellent short summary of the origins and rules of E.P.U. was published in *World Today*, July 1950, and of its later working in the *Midland Bank Review*, February, 1952.

of half of this additional surplus and receives gold from the Union for the other half. The corresponding further net deficits are settled by a combination of credits from the Union to the debtor country and gold payments by the debtor country to the Union. The proportion of gold payments increases the higher the debt. For example, the first 20 per cent of the debtor's quota is settled in credits from the Union; of the last 20 per cent of the debtor's quota, one-fifth is settled in credits received from the Union, four-fifths in gold payments to the Union. This procedure was designed to discourage countries from falling into debt with the Union. When the quota is exhausted, settlement in either direction is in gold.

If a country that has got into debt reduces this debt, the procedure is reversed. For example, as a result of the first instalment of debt reduction, the country receives gold and has its credit reduced in the same ratio as gold was paid and credit received during the last instalment of debt creation. This procedure was intended to encourage countries to reduce their debts with the Union.

The British Government at first felt reluctant to join this Union. The reason was that some E.P.U. countries held substantial sterling balances and some were willing to hold sterling without limit. This was of particular importance after the United Kingdom had entered into a special monetary arrangement with the Scandinavian countries in January 1950, forming a special kind of monetary area, often referred to as 'Uniscan' (United Kingdom and Scandinavia). Uniscan had led to the freeing of all but particularly heavy capital movements between the United Kingdom and Scandinavia, and also made provision for freer capital movements between Scandinavia and the R.S.A. The Scandinavians agreed to accept sterling in unlimited quantity. In return the Scandinavians were allowed to use sterling fairly freely for payment in transactions with third countries. This return to the traditional United Kingdom-Scandinavian monetary alliance meant that the Scandinavians were prepared to use sterling as an international currency. This was of special value to the United Kingdom since Sweden is a substantial holder of sterling balances. Now, under the E.P.U. offsetting arrangements, without qualification for the position of sterling, all current transactions would finally have had to be settled in E.P.U. units of account. This would have meant that outstanding sterling balances would either have become unusable for the duration of the E.P.U. agreement, which would have been

incompatible with Uniscan; or the Scandinavian sterling balances would have become convertible into E.P.U. units of account, which might have made the United Kingdom a substantial debtor to E.P.U. In either case the value of sterling would have been adversely affected.

However, a solution was found. The special position of sterling as an international currency was recognized and the United Kingdom became a full member of E.P.U. It was agreed that any net creditor is to be free to hold part of his balances in sterling instead of E.P.U. units of accounts. The United Kingdom negotiated special agreements with the countries concerned in which it was laid down what amounts they would hold in sterling. Net debtors to E.P.U. became entitled to settle parts of their debts to the Union by drawings on their existing sterling balances.

Whether by accident or by design Uniscan turned out to be a master-stroke of British economic diplomacy. It was an E.P.U. on a small scale. Perhaps it made the negotiations for E.P.U. more difficult, but it did not prevent it. It gave the United Kingdom added negotiating power, since some of the other countries that were to join E.P.U. had already agreed to use sterling as an international currency and had in a way already become members of an extended sterling area. The Scandinavian countries as members of Uniscan had also become interested in a special position for sterling. In consequence, sterling was, as it were, put back on the European map. Within E.P.U., sterling now is of equal importance with the gold- and dollar-based E.P.U. units of account. Without Uniscan this would hardly have been possible.

During the first ten months of its operation E.P.U. was a great success for the United Kingdom. The age-old story came true again, that in any economic area there is a tendency for gold to move to the richest centre, and in a union of (on balance) competitors to the most efficient of these competitors. Within E.P.U. the United Kingdom was the strongest and the most efficient economy. She became the principal creditor. Between July 1950 and April 1951 her net surplus with E.P.U. was £161 millions.[1] Out of this the United Kingdom gave £118 millions of credit to E.P.U. and received £43 millions in gold. In addition, other member countries reduced some of their sterling

[1] All E.P.U. figures in this section from International Monetary Fund: *International Financial Statistics*. Figures converted at the rate \$2.80 = £1.

balances and their drawing rights on the United Kingdom under earlier payments and compensation agreements. This wiped out United Kingdom debts to the amount of £83 millions. (This figure includes the United Kingdom's initial debt position in the Union of £54 millions). Hence there was an effective net extension of the United Kingdom into continental Marshall Europe by £244 millions during those ten months. This consisted of the actual extension of the United Kingdom economy (£161 millions) and reduced the extensions of other economies into the United Kingdom through reduction in United Kingdom indebtedness (£83 millions). The value of this extension of the United Kingdom economy into continental Marshall Europe went beyond the sum the United Kingdom earned. It strengthened the United Kingdom in the sterling area as well as generally. It showed that through the European monetary alliance the United Kingdom had an effective contribution to make to the sterling area's reserves and the value of the pound sterling, at a time when in the absence of the European monetary alliance the United Kingdom would have made little direct contribution to the sterling area's reserves.

Unfortunately this state of affairs did not persist. During the last eight months of 1951 the United Kingdom ran a substantial deficit with E.P.U. By October all the previous gains had been wiped out. By the end of the year the United Kingdom was in deficit with E.P.U. The deterioration of the United Kingdom's position during the last eight months of 1951 is summarized in the following figures:

| | Gold received (+) or paid (−) | Credit granted (+) or received (−) | Other Debt reduced (+) | TOTAL |
|---|---|---|---|---|
| | £ millions | | | |
| July 1950 to April 1951 .. | + 43 | +118 | + 83 | +244 |
| July 1950 to Dec. 1951 .. | − 61 | −192 | + 85 | −168 |
| Deterioration (−) or Improvement (+) of position, May 1951 to December 1951 .. | −104 | −310 | + 2 | −412 |

There was a net contraction of the United Kingdom economy

*vis-à-vis* the rest of Marshall Europe. Why this reversal in the United Kingdom's fortunes?

To some extent it was due to a decline in the R.S.A.'s balance of payments surplus with Marshall Europe. *Via* the United Kingdom the whole sterling area is in E.P.U., so that the R.S.A.'s fortunes affect the United Kingdom's. But this is not the full explanation. The R.S.A.'s balance of payments surplus with continental Marshall Europe fell from £157 millions in 1950 to £21 millions in 1951. During the second half of 1951 the R.S.A. had a deficit with continental Marshall Europe of £93 millions.[1] Even if this R.S.A. deficit had run at the same rate throughout the eight months, the R.S.A. could not have accounted for more than £124 millions of the reversal. In fact, the R.S.A.'s contribution to the deficit was less during those eight months. Hence the United Kingdom's own contribution to the deficit must have been about £300 millions.

The United Kingdom economy as a whole had not become less efficient. But the United Kingdom civilian economy was made to contract when it was decided that an increase in defence expenditure was necessary. Defence expenditure was about £300 millions greater in the financial year 1951-2 than in the financial year 1950-2.[2] But consumption in the United Kingdom did not fall appreciably.[3] Part of the 'gap' was filled through borrowing from continental Marshall Europe. Credit received minus gold paid and debt reduction amounted to £171 millions during those eight months. Capital imports from the R.S.A. (£173 millions during the whole of 1951) provided for the remainder.

The political framework was such that the increase in defence expenditure had to fall more heavily on Britain and France than on other European countries. Britain and France were the chief creditors in E.P.U. in April 1951. They experienced the biggest contractions of their civilian economies. By the end of the year they were the chief debtors. Other countries experienced smaller contractions or none at all. Consequently their civilian economies extended *vis-à-vis* those of Britain and France. The greatest improvements in their relative positions in E.P.U. were experienced by Belgium, Germany, Sweden, Italy and Switzerland. Owing to the mechanism of E.P.U. the increase

[1] Cmd. 8505.
[2] *Economic Survey for* 1952, Cmd. 8509, Table 7, p. 20.
[3] op. cit., Table 21, p. 40.

in the defence burden of Britain and France could for a time be financed to a large extent out of credits received from other E.P.U. countries, instead of immediate cuts in British and French consumption levels. At the time this had some advantages in terms of personal comfort for the British and French peoples. But it simply meant a postponement of the sacrifice, since repayments will have to be made sooner or later. Moreover, the credit facilities are limited by the quotas. In the meantime it lost Britain her leadership in E.P.U.

What happened was an unequal contraction of the civilian economies of the member countries. Given a more equal defence burden among member countries, Britain's leadership would soon reassert itself. If this is impossible, Britain and France can justly claim a larger share of American defence assistance than other E.P.U. countries, if only in view of what their additional defence contributions had cost them in E.P.U. Even without special aid it is not impossible that Britain will regain some of her strength in E.P.U., even while the present defence programme lasts, once her economy is adjusted to the new defence programme, particularly once the largest share of it is fulfilled. However this may be, other things being equal, it would appear that Britain's leadership in E.P.U. will reassert itself once the defence programme is fulfilled, and possibly even earlier.

To sum up: Union of competitors leads to greater external strength, a union of complementary economies to greater stability. Through the sterling area the United Kingdom is linked to complementary economies. In so far as R.S.A. countries suffer from the 'dollar shortage' they are competitive with the United Kingdom. Hence the sterling area monetary union gives the United Kingdom both stability and strength. In E.P.U. the United Kingdom is allied with competitive economies. This gives the United Kingdom strength. In so far as the European economic alliance will be allowed to lead to greater specialization within Western Europe, it will make these economies more complementary to each other and this way will give them stability.

On economic grounds there is nothing incompatible between the sterling area and intensification of Britain's economic alliance with continental Western Europe. Britain needs both and is equally needed by her partners in either union. Either union in strengthened by the success of the other. Britain is the link between the two.

The aims of economic policy are economic stability and economic strength. The best means to these ends in external economic policy lie in a strengthening of the links between the United Kingdom and both the R.S.A. and Western Europe to whatever extent is politically feasible.

# APPENDIX

## *THE PURE THEORY OF THE EXTERNAL ASPECT OF CUSTOMS UNION*

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### I

On purely economic grounds there are two inter-related aspects of the customs union issue. One is the internal aspect: the case for customs union there rests on the advantages of increased specialization within the union; the case against customs union on the extent to which the existing state of affairs is preferable to any alternative one. The other economic aspect is the external one: the effect on the member countries' position *vis-à-vis* outsiders (i.e. all countries not considered for inclusion in a proposed customs union). Here the question is whether a customs union would enable the participants to yield greater monopoly power and thus 'exploit' the rest of the world more efficiently than would be possible without it, or alternatively, whether such a customs union would enable its members to counteract more effectively the monopoly power of outsiders. The purpose of this appendix is to deal with this external aspect of the customs union issue, making use of the Marshallian offer curve technique.[1]

### II

Suppose in any geographical region there are a number of countries with economies of similar strength, competitive rather than complementary in character. Suppose further, that there is little competition with that region from outsiders. In this case any one country in the region, let it be called Alpha, finds her returns from trade largely determined by the competitive offers of her regional rivals. Thus, Alpha is faced by a foreign offer which she cannot appreciably influence through any action of her own. In the extreme case, the foreign offer will be perfectly elastic, represented on a Marshallian diagram by the straight line *OF* (see figure I, page 136). Alpha's offer, *OA*, determines the quantity of her participation in world trade. But, however

[1] cf. A. Marshall: *The Pure Theory of Foreign Trade.*

much she may restrict her offer, e.g. to $OA_1$, or expand her offer, e.g. to $OA_2$, the terms of trade are determined by the foreign offer $OF$. If the outside world is monopolistically organized *vis-à-vis* Alpha it can alter the terms of trade to, say, $OF_1$ or $OF_2$ and Alpha is unable to retaliate.

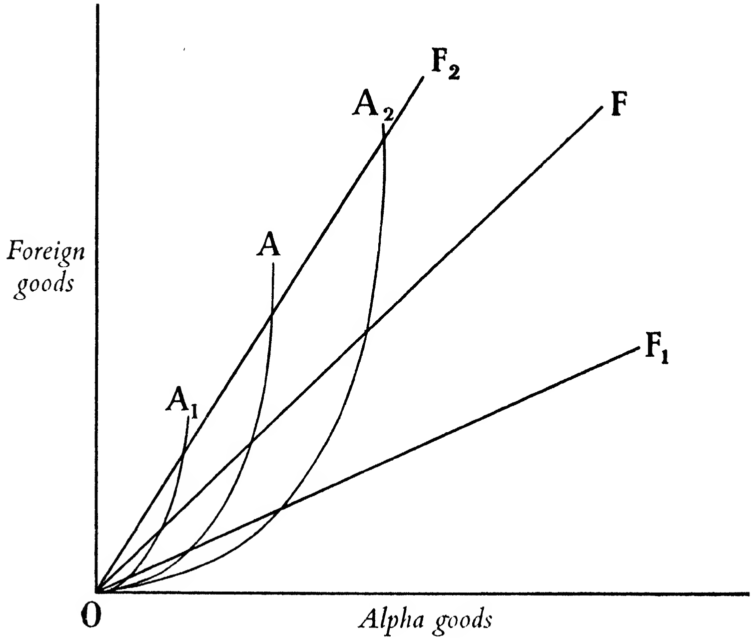


*Fig.* 1

The extreme case of Alpha being faced by a perfectly elastic foreign offer is applicable only if certain conditions are satisfied. Alpha must be such an insignificant participant in world trade that any change in her offer has no, or only a negligible, effect on outsiders. The offer of Alpha's competitors must be perfectly elastic within the relevant limits, so that any change in Alpha's offer is easily compensated. If both these conditions are satisfied — in fact if one of them is satisfied, the other automatically follows — then no amount of monetary or fiscal or other economic autonomy will enable Alpha to take any independent action to alter her terms of trade. Usually, however, a country's

participation in world trade makes at least some difference in the market. This certainly will be so within the assumption of Alpha competing with a number of countries of equal economic strength, as long as their number is not legion. Again, normally it cannot be assumed that there will be no resources in Alpha's competitors that could without cost become employed or be thrown out of employment in industries competing with Alpha. It follows that the assumption of absolutely perfect competition in international trade cannot be maintained. Consequently a country with autonomous economic policy can exert some influence on its terms of trade.

Equally the assumption of the outside world enjoying a perfect monopoly in trade with Alpha will seldom be tenable. It is applicable only where there is but one potential outside buyer and there is no substantial home market for the products concerned, and Alpha is tied to a monopolistic buying organization in the other country either because of political subjection or as a result of a commercial treaty (e.g. a bulk purchase contract for the total export trade).

Therefore it is necessary to assume imperfect competition as the rule in international trade. If the degree of imperfection of competition is the same both ways, the Alpha offer and the foreign offer are iso-elastic. The gains from trade will be shared in the same proportions as if there were perfect competition. But if the two offers are not iso-elastic, a state of affairs approaching that pictured in figure 1 can prevail. In this case Alpha sells under (relatively) competitive conditions and buys under (relatively) monopolistic conditions. Since neither the monopoly nor the competition is perfect, Alpha can take some independent action to improve her position. The limits are set by the discrepancies in the elasticities by the two offers. In general, the more elastic Alpha's offer relatively to the foreign offer, the greater is Alpha's monopoly power and her ability to improve her position by independent action; and the less elastic Alpha's offer is relatively to the foreign offer, the less scope will there be for independent action on the part of Alpha. Figure 1 is an exaggerated picture of a state of affairs where Alpha's ability to improve her terms of trade by independent action is at a minimum.

## III

Alpha can take independent action either by means of trade restriction, e.g. by tariff, or by means of trade expansion, e.g. by devaluation of her currency.[1] Trade restriction implies that a country reduces its offer in the hope of obtaining foreign goods at a lesser price per unit, at the cost of a smaller volume of trade.

[1] Devaluation will not always lead to trade expansion. If conditions are unfavourable it may lead to trade restriction. In such a case the policy is wrong, since the same result could have been achieved by a tariff with improvement, instead of deterioration of the terms of trade (See below). Therefore it can be assumed that the purpose of devaluation is expansion of trade beyond its existing level.

This cost will be the greater and the gain the less, the more elastic the foreign demand. In the extreme case shown in figure 1 Alpha gains no improvement in her terms of trade if she reduces her participation in world trade by imposition of an exploitative tariff.[1] Trade expansion through price cutting implies

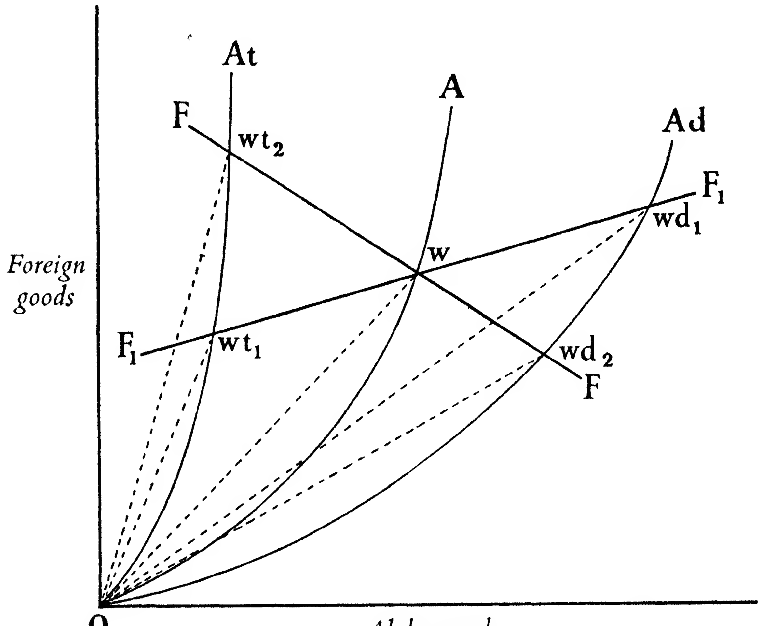


*Fig.* 2

that the country wishes to expand her participation in world trade, even at the cost of a deterioration in the terms of trade. Here the cost will be the less and the

[1] A tariff is purely exploitative if it is imposed on goods that do not compete with Alpha industry. It diverts some of the profits of trade from foreigners to Alpha. Revenue tariffs tend to be exploitative tariffs, whatever the intention of those who impose them. True, a protective tariff is 'exploitative' in the sense that competitors are hurt. But in so far as the competitors' loss is compensated through geographical transfer of production the industry as a whole is not exploited, and outsiders are exploited only to the extent to which this protection leads to greater monopoly power over them. In the latter case the effects on real income distribution between industries is the same as if a 'revenue' tariff has been imposed on complementary goods.

benefit the greater, the more elastic the foreign offer. In the extreme case shown in figure 1, Alpha can expand trade without cost through deterioration of the terms of trade. The position under imperfect competition is illustrated in figure 2 (see page 138).

On figure 2, let *OA* be Alpha's original offer, and *OAt* Alpha's offer after the imposition of the tariff. *FF* is a section of the foreign offer curve with elasticity less than unity throughout the relevant range. It intersects *OA* at *W*, *OW* being the original terms of trade. $F_1F_1$ is a section of an alternative foreign offer curve which also cuts *OA* at *W*, but has an elasticity greater than unity throughout the relevant range. If Alpha restricts trade the improvement in the terms of trade is greater if the foreign offer is less elastic (from *OW* to $OWt_2$) than if the foreign offer is more elastic (from *OW* to $OWt_1$). If Alpha expands her offer from *OA* to *OAd*, the cost of expansion through deterioration of the terms of trade is greater if the foreign offer is less elastic (from *OW* to *OWd*) than if it is more elastic (from *OW* to $OWd_1$).

## IV

It has been shown that exploitative tariff action will be the more successful the less elastic the foreign offer. The elasticity of the foreign offer depends on the nature of the commodities Alpha offers in exchange for foreign goods, and, given the nature of the commodities, on the proportion of trade controlled by Alpha. Now, assuming that the offers by Alpha and by each of her rivals are for all practical purposes perfectly substitutable, Alpha is faced by a foreign offer that is more elastic than the offer facing the group as a whole. (The demand for a commodity is always less elastic than the demand for the product of one of a number of suppliers producing perfect substitutes). It follows that the larger the number of competitive economic units, the less effective will be exploitative tariff action by any one of them. If Alpha were a larger supplier than her competitors, or if Alpha is one of sufficiently few competitors so that any change in Alpha's offer could not easily be compensated, then independent tariff action by Alpha will be correspondingly more effective.

If there is full employment of factors of production in Alpha, but there are unemployed resources at the disposal of her competitors, Alpha is a potentially smaller supplier than would be the case if there were an equal level of employment all round. This reduces Alpha's ability to take exploitative tariff action which is the more effective the more unused resources there are at her disposal relatively to the amount of unused resources in the rival economies. But if Alpha has more unemployed resources than her competitors then, *ceteris paribus*, the elasticity of her offer relatively to the foreign offer is greater than the elasticities of her rivals' offers relatively to the foreign offer, so that Alpha is in a more favourable position to use effectively exploitative tariff action than are her rivals.

Thus, if Alpha is not larger than her rivals, and the number of rivals is great and there is fuller employment of resources in Alpha than in the rival economies, independent tariff action by Alpha is correspondingly ineffective. It will be in Alpha's interest to take steps that will make her own offer appear relatively

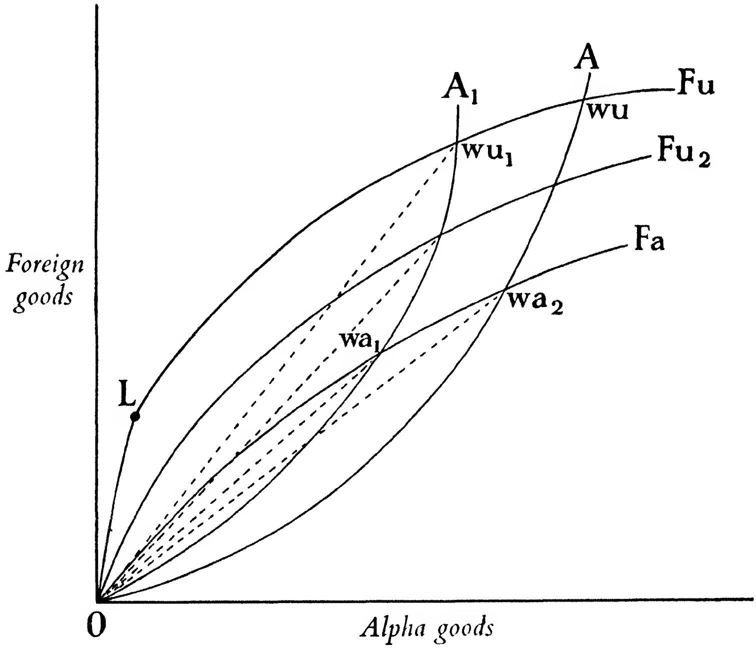


*Fig.* 3

more elastic. Independent action being ineffective she will have to act jointly with her rivals *vis-à-vis* outsiders, if she wants to enjoy a higher degree of monopoly in her trade relations with outsiders or to counteract an outsiders' monopoly.

An arrangement, such as e.g. a customs union, that forces Alpha and her competitors to act together *vis-à-vis* outsiders enables the participants to exert a high degree of monopoly *vis-à-vis* outsiders. The latter will have to have greater regard to the terms at which the union is prepared to trade. The wider free trade area leads to an increase in internal competition and thus to the

establishment of a union price level over a larger area than before. Hence union prices will have greater impact on world prices, and the union will be in a stronger bargaining position in trade negotiations than Alpha acting in isolation. (See below). The outsiders' offer will be correspondingly less elastic from the point of view of the union than from the point of view of potential member countries acting in isolation, *OFu* instead of *OFa* in figure 3 (see page 140). Consequently the terms of trade will be more favourable to Alpha in the state of union (*OWu*) than in the state of isolation (*OWa*).

It follows that the extent to which customs union increases external economic strength depends on how embracing the union is. If the union still has to contend with competition from other suppliers, the outsiders' offer will become correspondingly less inelastic and the terms of trade stand less chance of improvement. Diagrammatically this would lead to an outsiders' offer somewhere between *Fa* and *Fu*, say $Fu_2$, in figure 3. Thus, if Alpha's rivals form a customs union, and Alpha remains isolated, Alpha has to trade with outsiders largely on the terms obtained by the now very powerful rival. To the extent to which the rival improves the terms of trade Alpha benefits (assuming the absence of discrimination), but she has correspondingly less influence over price ratios. In other words, isolated action by Alpha will be correspondingly less effective. If union strengthens her rivals and Alpha does not want to lose influence over price ratios, she will prefer to be a founder member of such a union rather than wait for later admittance on her rival's terms or to remain in weakened isolation.

Maximum economic power over outsiders can be attained only if all competitive economies are included in the union and all others excluded. There also must be no danger of retaliation. This is the case of the commodity control schemes. It is unattainable through customs union, since it is difficult to visualize a union of countries that could entirely fulfil these conditions. Customs union can increase the degree of monopoly over outsiders, but cannot make it perfect. Another limitation to the power of customs union arises because the increase in absolute economic power is not accompanied by a proportionate increase in the union's power to improve the terms of trade further by tariff action. The increase in this relative tariff power is limited to that section of the *OFu* curve on figure 3 that is less elastic than the *OFa* curve at the latter's point of intersection with *OA*. On figure 3 this will be approximately at point *L* on the *OFu* curve. If the union restricts trade so that $OA_1$ cuts *OFu* at *L*, the terms of trade are, of course, much more favourable than in isolation. But further improvements in the terms of trade will be proportionately no greater than the relative improvements that could be effected in isolation. In general, the limit to an increase in relative tariff power is set by the fact that the more a country restricts trade, the less elastic is its offer (i.e. the sum of the elasticities of the alternative offers represented on *OA* is greater than the sum of the

elasticities on $OA_1$.[1] Since the foreign offer has become less elastic through Alpha's union with her competitors, the limit to the increase in relative tariff power over outsiders has been pushed further, but is not completely eliminated. Thus the power to effect further improvements in the terms of trade in the state of union is on the whole greater than in isolation, but not necessarily proportionately greater. On figure 3 it is proportionately greater as long as the point of intersection of the two offers is to the right of $L$, and proportionately less if it is to the left of $L$.

However, as long as the union does not attempt to restrict trade too much (i.e. beyond $L$), absolute and relative tariff power is increased. This enhances bargaining strength in trade negotiations with outsiders. Outsiders will grant larger concessions to the union than to member countries acting in isolation. This is so, because an outsider will be loath to grant the maximum tariff or quota concession possible to a relatively unimportant supplier, since owing to the operation of the most-favoured-nation clause any such concession would have to be generalized. The conceding country then wastes its negotiating strength towards others, if it grants the full concession to one single supplier. Hence trade negotiators acting on behalf of the union as a whole probably will be able to extract bigger concessions than if they represent a fraction of the suppliers only. In any case the full concession will be obtained more speedily the more embracing the union of competitive economies. Since it is assumed that the products of any one of these competitive economies are perfect substitutes for the products of any other of them, this will benefit all parts of the customs union area alike.

If Alpha and her rivals produce and demand close, but not perfect, substitutes, the results are not so certain. In this case the elasticity of the foreign offer is less reduced, according to the degree of divergence from perfect substitutability. However, as long as the offers of Alpha and her rivals are such that they can be regarded as substitutes rather than complements, the tendency will be as outlined above. Less certain will be the beneficial effects of speedier and larger concessions to the whole group. Should it so happen that Alpha can obtain a concession for her particular variety of products which is not extended to close substitutes of interest to her rivals, Alpha would obtain a more valuable concession in isolation, as long as she can ensure that no equivalent concessions are granted to her rivals. This applies only where the outsider concerned has guaranteed preferential treatment to Alpha or for any other reason cannot in the long run act without Alpha's consent. Thus, even as far as negotiating strength *vis-à-vis* outsiders is concerned the usual tendency will be as outlined in preceding paragraphs.

[1] This is so since the $OA_1$ curve is a derived curve with direction of slope determined by OA. If $OA_1$ were an independent curve its arc elasticity could, of course, be greater than that of OA, even though it is to the left of it.

A customs union between Alpha and an economy that is complementary to, rather than competitive with, Alpha's economy would confer no such advantage on Alpha. Alpha can exploit a complementary economy by means of an exploitative tariff. Should it be to Alpha's advantage to rescind such a tariff she could do so in isolation as well as in a state of customs union. True, if Alpha is joined in a customs union with a large number of complementary economies, while Alpha's competitors have no such connections, Alpha may exert pressure to be exempt from the exploitation of her competitors practised by her customs union partners. But Alpha may just as well be subject to exceptionally heavy exploitation because she has abandoned her powers of retaliation. In any case it is the union of competitive economies to which, for whatever reason, complementary Alpha is joined, that yields the enhanced economic power. Alpha's participation either makes little difference to the union or may even weaken it *vis-à-vis* outsiders. Thus, the case for customs union in its external aspect that stands a chance of carrying conviction must be a case for the union of competitors. It is analogous to the case for a trade union or a cartel or any other organization of competitors for the purpose of obtaining better terms from outsiders.

The external benefits of customs union thus depend on unified action *vis-à-vis* outsiders (with economies complementary to the union's). The administrative problems involved are simplified by the adoption of a common tariff, but from the point of view of the problem under consideration this is not absolutely essential as long as tariff changes affecting the union's external trade are made jointly by the members of the union. It is not even essential that internal trade barriers are removed. In the extreme case of two or more absolutely equal economies with similar tariff structures joining into a customs union, the exchange ratios between commodities are the same in the various constituent economies, so that there is no scope for increased internal specialization. In this extreme case the removal of internal tariff barriers would make no appreciable difference to trade.

Such extreme cases hardly exist. Normally different countries' economies are neither completely competitive nor completely complementary. True, either the competitive or the complementary aspect will predominate and this will determine whether external economic power can be increased by customs union. But the continuance or removal of internal trade barriers will seldom, if ever, be of identical incidence; hence their removal affects internal price ratios. This removal of internal tariff barriers is the most widely discussed aspect of the customs union issue. It is not proposed to enter into a detailed discussion of this aspect of the problem in this Appendix, except to the extent to which it affects the external aspect. It cannot be ignored, since it implies that the union offer will not be identical with the Alpha offer as has been assumed so far. This will somewhat modify the conclusions.

V

A customs union that is not confined to tariff action *vis-à-vis* outsiders, but implies the removal of internal tariff barriers, is a step in the direction towards internal economic union. There will be at least some increase in internal

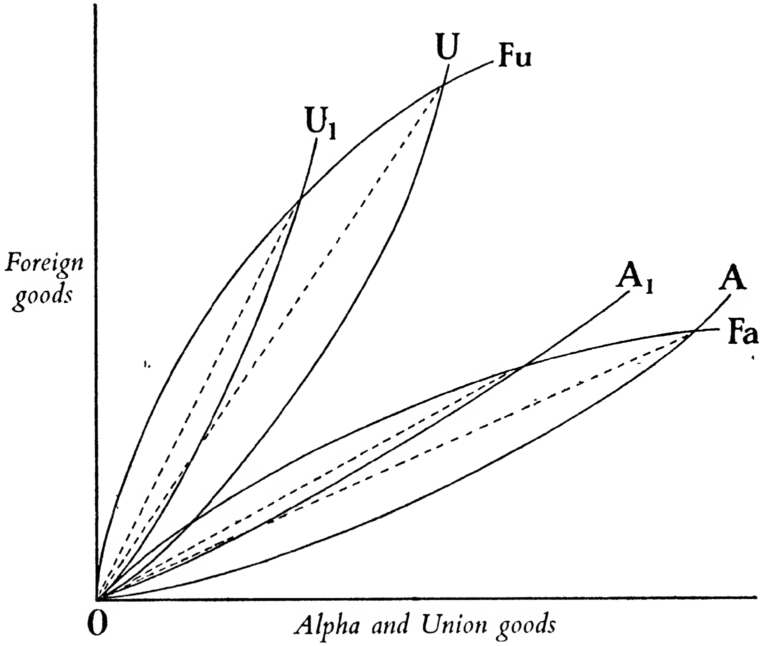


*Fig.* 4

mobility of factors within the union. Consequently the union offer will be more elastic than Alpha's isolated offer. The position of fuller economic union is represented in figure 4 (see above), where the Alpha offer becomes merged into the more elastic union offer *OU*. The comparative effects of trade restriction on the terms of trade by isolated action from *OA* to $OA_1$ and in the state of union from *OU* to $OU_1$ is indicated by the broken lines in the diagram.

The union's absolute tariff power *vis-à-vis* third parties will be greater in the case of fuller economic union than in the case of a mere tariff union. Within the limits discussed in section IV the same is true of relative tariff power. It

does not follow that every country will benefit more from full economic union than from a mere tariff union.

The offers so far considered, the *OA* and *OF* ones, are offers for the exchange of complementary goods, or rather goods where the complementary character

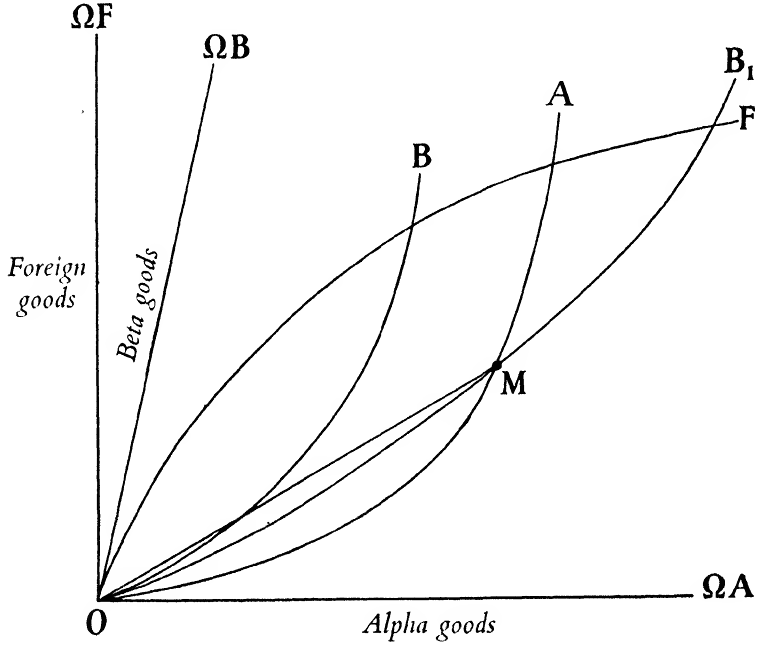


*Fig.* 5

outweighs the element of substitutability. On a diagram these offers will be drawn convex to their respective origins $\Omega A$ and $\Omega F$ (figure 5, see above); both offers have positive elasticities as seen from their respective origins (or elasticities of opposite signs as seen from the same origin). The actual and potential points of intersection of these curves are actual and potential trading points and a straight line connecting such points of intersection with O represents the relevant terms of trade. But when Alpha's trade relations with a competitor, say Beta, are considered, the two curves are convex to the same origin. In figure 5, *OB* is convex to $\Omega A$ and concave to its own origin $\Omega B$.

That is, seen from $\Omega B$, $OB$ is of negative elasticity (or seen from $\Omega A$ both the $OA$ and the $OB$ curves are of positive elasticity). An apparent point of intersection between a Beta offer curve, say $OB_1$, and the Alpha offer curve $OA$ is not a trading point, but a point of identity whenever the elasticities of the two curves are of opposite signs as seen from their respective origins (or of identical signs as seen from the same origin). Point $M$ is the one point in figure 5 where Alpha and Beta independently would enjoy the same terms of trade with third parties (as shown by the straight line $OM$) if $OF$ passed through $M$. $M$ is a point of equilibrium between Alpha and Beta, where neither side can undersell the other. In the previous sections, where the Alpha and the Beta offers were assumed to be identical this held true throughout the range of the curve, or rather the two identical curves. Where there is such identity there is no advantage in switching from one competitive offer to the other; where there is no such identity of rival offers this will be advantageous. If Alpha and Beta are rival monopolies their respective offer curves will show the terms at which they are trying to trade without regard to the competitive offer. Where, for example, as a result of the disappearance of internal trade barriers, the two offers cannot remain as independent as before, the $OA$ and $OB$ (or $OB_1$) curves become the limits of a plane or range of indeterminateness within which the joint offer will lie. The joint offer is not an average of $OA$ and $OB$, but will be nearer to $OA$ or to $OB$ according to circumstances, as will be shown in the following paragraphs.

Suppose the outsiders' offer is 'alternative', i.e. could be satisfied by trading with either Alpha or Beta. If the Alpha and Beta offers are represented by $OA$ and $OB$, Alpha can undersell Beta. Outsiders will trade exclusively with Alpha. Beta can enter the market only if she is satisfied with the terms Alpha can obtain. Beta must cheapen her offer by devaluation or otherwise if she wants to trade with outsiders. Union with Alpha could not help Beta. Moreover, if the Beta offer *vis-à-vis* the outside world competes with her own home market, the opening of the frontier between Alpha and Beta would lead to Alpha underselling Beta in the latter's home market. However, if this increase in Alpha trade leads to an increase in costs in Alpha, so that the Alpha price becomes more equal to, or even higher than, the Beta price, Beta would benefit from union with Alpha.

This last problem is illustrated by the relationship of $OA$ and $OB_1$ in figure 5. Alpha undersells Beta between $O$ and $M$. There the plane is twisted and thereafter Beta undersells Alpha. It would be to Alpha's interest if the outsiders restricted their offer so that $OF$ cuts the Alpha and Beta curves to the left of $M$.

If the volume of trade is then adequate for her requirements, Alpha is not interested in a strengthening of joint tariff power *vis-à-vis* outsiders. For Beta, on the other hand, union would ensure the maintenance of her advantage

unless the opening of the Alpha market to her would lead to diminishing returns in Beta.

Suppose now, that the outsiders' offer is 'additive', i.e. could not be satisfied by trading with either Alpha or Beta alone, but required trade with both. If there is perfect competition between Alpha and Beta, the marginal unit determines the price. If *OA* and *OB* are the relevant offers, the marginal offer is the Beta offer. The Beta price prevails and Alpha earns a rent of efficiency. If the outsiders are monopolistically organized and can discriminate between Alpha and Beta, Beta receives a better price than Alpha, but the gain at Alpha's expense accrues to the outsiders and not to Beta. Even Beta might lose: for the outsiders' offer facing Beta alone is more elastic than the outsiders' offer facing the group as a whole. The outsiders can threaten Beta to divert their offer to Alpha and thus reduce the price Beta receives to a level as low or almost as low as the Alpha level. Thus, while joint action by Alpha and Beta would ensure the more favourable Beta price, isolated action can in the worst case reduce the price received by each to the less favourable Alpha price.

Similar results ensue if Beta is in a relatively monopolistic position *vis-à-vis* Alpha, because Beta receives preferential treatment from outsiders. If outsiders tax trade with Alpha more heavily than trade with Beta, Beta is better off than Alpha but does not necessarily receive the full margin of preference. The greater elasticity of the foreign offer facing Beta in isolation still reduces the price she receives below the competitive price, though not by as much as if the monopoly were enjoyed by the outsiders only. In this case Alpha loses as much as in the former case, but the gains at her expense are shared by the outsiders and Beta. Alpha once more has everything to gain from union with Beta; Beta too benefits, but loses her relative advantage over Alpha; the outsiders lose from such a union between Alpha and Beta. Beta will gain more from preference accorded to her by the outsiders than from union with Alpha only if she is a relatively unimportant supplier: the outsiders could satisfy their demand by trading with Alpha only, but give a preference to Beta. This transforms what from Beta's point of view would have been an alternative outsiders' offer into an additive outsiders' offer with guarantee that Beta's claims are met first. In this case, and in this case only, will Beta gain as much externally from a preference over Alpha as from union with Alpha and perhaps even more: for if Alpha alone could have satisfied the outsiders' offer Beta would not trade at all without the preference.

Figure 4 thus represents the position correctly for the union and Alpha in the absence of increasing cost in Alpha through undue expansion of internal trade. For Beta the gains are less than for Alpha, and may even be negative in the case of sacrifice of a preference that benefits Beta. In such circumstances Beta will consider union only if the gain from reduction in the elasticity of the outsiders' offer at least compensates for the loss of preference.

VI

Customs union strengthens tariff action *vis-à-vis* outsiders, as does horizontal integration generally in respect of the appropriate action. Success depends on an inelastic outsiders' offer.

If Alpha is not so much interested in her terms of trade as in her quantitative share of trade with outsiders she will not consider customs union or any union with her competitors. She will resort to policies, such as devaluation of her currency below its market parity in order to capture some of her competitors' trade. Such action leads to a lesser deterioration of the terms of trade the more elastic the foreign offer. The aims and conditions for success of undervaluation are thus the very antithesis of the aims and conditions for success of tariff action reinforced by customs union (see figure 2). The most favourable conditions for the success of undervaluation are those pictured in figure 1, where Alpha is such an insignificant country that other countries do not react in any way to a change in her offer. If this is not attainable, it is necessary for the foreign demand to be alternative, rather than additive. In general, whenever the conditions for the success of a customs union are least favourable, the conditions for successful undervaluation are most favourable. The requisite policies are opposites. Undervaluation is the antithesis of customs union, not an alternative to it (as would be overvaluation). Undervaluation is directed against Alpha's competitors and benefits complementary economies through the deterioration of Alpha's terms of trade. Customs union is directed against complementary economies and within certain limits helps Alpha and her competitors through the improvement in the terms of trade.[1]

[1] Nothing in this section should be regarded as an adverse criticism of the devaluation of sterling in 1949, which put an end to overvaluation when the foreign offer ceased to be inelastic. At that time there seemed to be no prospect of any policy that would have made the foreign offer relatively less elastic.

# INDEX